Consolidation of VIEs

As amended by ASU 2015-02

US GAAP

April 2018
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1. Introduction

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1.1. OVERVIEW

1.1.10. About This Book

1.1.10.10. U.S. GAAP currently contains two primary consolidation models, the voting control model and the variable interest entity (VIE) model, the applicability of which depends on the characteristics of an entity’s equity and its governance. This book provides interpretive guidance related to the VIE consolidation model and reflects KPMG’s current understanding of the VIE Subsections of FASB Accounting Standards Codification® (ASC) Subtopic 810-10, Consolidation – Overall, as amended by FASB Accounting Standards Update Nos. 2015-02 (ASU 2015-02), Amendments to the Consolidation Analysis, and 2016-17 (ASU 2016-17, Interests Held through Related Parties That Are under Common Control, including our understanding of the views of the FASB and SEC staffs.1 Our interpretations may be affected by future guidance issued by the FASB or its staff, the SEC staff, and others involved in the standard-setting process. We recommend that companies refer to the texts of the Codification and consult their accounting and other professional advisors when considering the implications of applying these sections of the Codification.

1.1.10.20. Enterprises evaluating whether to consolidate an entity are required to first determine whether the entity is subject to the VIE consolidation requirements of ASC Subtopic 810-10, as indicated in ASC paragraph 810-10-15-3. Only if an entity with which a reporting enterprise is involved is not subject to the VIE consolidation model would the voting control consolidation model apply.

1.1.10.25. In September 2017, the FASB issued a proposed ASU, Reorganization, that would reorganize the consolidation guidance. The proposed amendments would replace ASC Topic 810 with ASC Subtopic 812-20 for variable interest entities and ASC Subtopic 812-30 for voting interest entities. Each Subtopic would be complete with its own scope through disclosure sections. The proposal also would:

- Provide further guidance about how to apply the concept of ‘expected’ as it relates to the definitions of variable interests, expected losses and expected residual returns.
- Clarify existing language about when an implicit variable interest exists.
- Move guidance about consolidation of entities controlled by contract from ASC Topic 810, Consolidation, to ASC Topic 958, Not-for-Profit Entities.
- Remove the guidance about research and development entities in ASC Subtopic 810-30.

Comments on the proposal were due December 4, 2017.

1 Readers interested in the VIE interpretive guidance applicable to reporting enterprises prior to the initial application of ASU 2015-02 can refer to Consolidation of Variable Interest Entities, A KPMG Analysis of the VIE Subsections of ASC Subtopic 810-10 (Revised May 2012).
Excerpt from ASC 810-10

05 Overview and Background

General Note on Consolidation—Overall

Under this Subtopic, there are two primary models for determining whether consolidation is appropriate:

(a) The voting interest entity model
(b) The variable interest entity (VIE) model.

Additional analysis also is required for consolidation of entities controlled by contract, which is applicable to entities that are not VIEs in this Subtopic.

Under the voting interest entity model, for legal entities other than limited partnerships, the usual condition for a controlling financial interest is ownership by one reporting entity, directly or indirectly, of more than 50 percent of the outstanding voting shares of another entity (see paragraph 810-10-15-8). For limited partnerships, the usual condition for a controlling financial interest is ownership by one limited partner, directly or indirectly, of more than 50 percent of the limited partnership’s kick-out rights through voting interests (see paragraph 810-10-15-8A). If noncontrolling shareholders or limited partners have substantive participating rights, then the majority shareholder or limited partner with a majority of kick-out rights through voting interests does not have a controlling financial interest.

Under the VIE model, a controlling financial interest is assessed differently than under the voting interest entity model. This difference in assessment is required because a controlling financial interest may be achieved other than by ownership of shares or voting interests. A controlling financial interest in the VIE model requires both of the following:

(a) The power to direct the activities that most significantly impact the VIE’s economic performance
(b) The obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE.

A reporting entity with a controlling financial interest in a VIE is referred to as the primary beneficiary (see paragraph 810-10-25-38A). The reporting entity could be, but is not limited to being, an equity investor, some other capital provider such as a debt holder, or a party with another contractual arrangement such as a guarantor. This model applies to all types of legal entities within the scope of the Variable Interest Entities Subsections of this Subtopic that meet the definition of a VIE (see paragraph 810-10-15-14).

To determine which accounting model applies and which reporting entity, if any, must consolidate a particular legal entity, after a reporting entity determines that it has a variable interest, it must determine whether the legal
entity is a VIE or a voting interest entity (see paragraph 810-10-15-14), unless a scope exception applies (see paragraph 810-10-15-12).

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

(a) If the reporting entity has an interest in an entity, it must determine whether that entity is within the scope of the Variable Interest Entities Subsections in accordance with paragraph 810-10-15-14. If that entity is within the scope of the Variable Interest Entities Subsections, the reporting entity should first apply the guidance in those Subsections. Paragraph 810-10-15-17 provides specific exceptions to applying the guidance in the Variable Interest Entities Subsections.

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

(c) If the reporting entity has a contractual management relationship with another entity that is not within the scope of the Variable Interest Entities Subsections, the reporting entity should use the guidance in the Consolidation of Entities Controlled by Contract Subsections to determine whether the arrangement constitutes a controlling financial interest.

15-8 For legal entities other than limited partnerships, the usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one reporting entity, directly or indirectly, of more than 50 percent of the outstanding voting shares of another entity is a condition pointing toward consolidation. The power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other stockholders, or by court decree.

15-8A Given the purpose and design of limited partnerships, kick-out rights through voting interests are analogous to voting rights held by shareholders of a corporation. For limited partnerships, the usual condition for a controlling financial interest, as a general rule, is ownership by one limited partner, directly or indirectly, of more than 50 percent of the limited partnership’s kick-out rights through voting interests. The power to control also may exist with a lesser percentage of ownership, for example, by contract, lease, agreement with partners, or by court decree.

15-9 A majority-owned subsidiary is an entity separate from its parent and may be a variable interest entity (VIE) that is subject to consolidation in accordance with the Variable Interest Entities Subsections of this Subtopic.
Therefore, a reporting entity with an explicit or implicit interest in a legal entity within the scope of the Variable Interest Entities Subsections shall follow the guidance in the Variable Interest Entities Subsections.

1.1.20. Establishment of the VIE Consolidation Model

1.1.20.10. The FASB developed the VIE consolidation model (referred to as FIN 46(R) and codified in the VIE Subsections of ASC Subtopic 810-10) primarily because of concerns about consolidation practices by enterprises involved with special-purpose entities (SPEs).\(^2\) The term variable interest entity was used instead of special-purpose entity because some entities considered to be SPEs under U.S. GAAP at that time were outside the scope of FIN 46(R) and some entities not considered to be SPEs under GAAP at that time were within its scope. The objective of FIN 46(R) was to provide consolidation guidance for situations where voting interests do not adequately reflect the controlling interests in an entity (e.g., where investors lack the characteristics of a controlling financial interest or lack sufficient equity at risk for the entity to operate without additional subordinated financial support from other parties).

Excerpts from ASC 810-10

05-8 The Variable Interest Entities Subsections clarify the application of the General Subsections to certain legal entities in which equity investors do not have sufficient equity at risk for the legal entity to finance its activities without additional subordinated financial support or, as a group, the holders of the equity investment at risk lack any one of the following three characteristics:

(a) The power, through voting rights or similar rights, to direct the activities of a legal entity that most significantly impact the entity’s economic performance

(b) The obligation to absorb the expected losses of the legal entity

(c) The right to receive the expected residual returns of the legal entity.

Paragraph 810-10-10-1 states that consolidated financial statements are usually necessary for a fair presentation if one of the entities in the consolidated group directly or indirectly has a controlling financial interest in the other entities. For legal entities other than limited partnerships, paragraph 810-10-15-8 states that the usual condition for a controlling financial interest is ownership of a majority voting interest. For limited partnerships, paragraph 810-10-15-8A states that the usual condition for a controlling financial interest is ownership of a majority of the limited partnership’s kick-out rights through voting interests. However, application of the majority voting interest and kick-out rights requirements in the General Subsections of this Subtopic to certain

\(^2\) FASB Interpretation No. 46 (FIN 46), Consolidation of Variable Interest Entities, January 2003, and FASB Interpretation No. 46 (revised December 2003) (FIN 46(R)), Consolidation of Variable Interest Entities, December 2003.
types of entities may not identify the party with a controlling financial interest because the controlling financial interest may be achieved through arrangements that do not involve voting interests or kick-out rights.

05-9 The Variable Interest Entities Subsections explain how to identify VIEs and how to determine when a reporting entity should include the assets, liabilities, noncontrolling interests, and results of activities of a VIE in its consolidated financial statements. Transactions involving VIEs are common. Some reporting entities have entered into arrangements using VIEs that appear to be designed to avoid reporting assets and liabilities for which they are responsible, to delay reporting losses that have already been incurred, or to report gains that are illusory. At the same time, many reporting entities have used VIEs for valid business purposes and have properly accounted for those VIEs based on guidance and accepted practice.

05-10 Some relationships between reporting entities and VIEs are similar to relationships established by majority voting interests, but VIEs often are arranged without a governing board or with a governing board that has limited ability to make decisions that affect the VIE’s activities. A VIE’s activities may be limited or predetermined by the articles of incorporation, bylaws, partnership agreements, trust agreements, other establishing documents, or contractual agreements between the parties involved with the VIE. A reporting entity implicitly chooses at the time of its investment to accept the activities in which the VIE is permitted to engage. That reporting entity may not need the ability to make decisions if the activities are predetermined or limited in ways the reporting entity chooses to accept. Alternatively, the reporting entity may obtain an ability to make decisions that affect a VIE’s activities through contracts or the VIE’s governing documents. There may be other techniques for protecting a reporting entity’s interests. In any case, the reporting entity may receive benefits similar to those received from a controlling financial interest and be exposed to risks similar to those received from a controlling financial interest without holding a majority voting interest (or without holding any voting interest). The power to direct the activities of a VIE that most significantly impact the entity’s economic performance and the reporting entity’s exposure to the entity’s losses or benefits are determinants of consolidation in the Variable Interest Entities Subsections. The Variable Interest Entities Subsections also provide guidance on determining whether fees paid to a decision maker or service provider should be considered a variable interest in a VIE.

05-11 VIEs often are created for a single specified purpose, for example, to facilitate securitization, leasing, hedging, research and development, reinsurance, or other transactions or arrangements. The activities may be predetermined by the documents that establish the VIEs or by contracts or other arrangements between the parties involved. However, those characteristics do not define the scope of the Variable Interest Entities Subsections because other entities may have those same characteristics. The
distinction between VIEs and other entities is based on the nature and amount of the equity investment and the rights and obligations of the equity investors.

**05-12** Because the equity investors in an entity other than a VIE generally absorb losses first, they can be expected to resist arrangements that give other parties the ability to significantly increase their risk or reduce their benefits. Other parties can be expected to align their interests with those of the equity investors, protect their interests contractually, or avoid any involvement with the entity.

**05-13** In contrast, either a VIE does not issue voting interests (or other interests with similar rights) or the total equity investment at risk is not sufficient to permit the legal entity to finance its activities without additional subordinated financial support. If a legal entity does not issue voting or similar interests or if the equity investment is insufficient, that legal entity’s activities may be predetermined or decision-making ability is determined contractually. If the total equity investment at risk is not sufficient to permit the legal entity to finance its activities, the parties providing the necessary additional subordinated financial support most likely will not permit an equity investor to make decisions that may be counter to their interests. That means that the usual condition for establishing a controlling financial interest as a majority voting interest does not apply to VIEs. Consequently, a consolidation analysis that focuses on ownership of voting stock is not appropriate for such entities.

**55-16** The Variable Interest Entities Subsections provide guidance for identifying entities for which analysis of voting interests, and the holdings of those voting interests, is not effective in determining whether a controlling financial interest exists because the holders of the equity investment at risk do not have sufficient equity at risk for the legal entity to finance its activities without additional subordinated financial support or because they lack any of the following:

(a) The power, through voting rights or similar rights, to direct the activities of a legal entity that most significantly impact the entity’s economic performance

(b) The obligation to absorb the expected losses of the legal entity

(c) The right to receive the expected residual returns of the legal entity.

Those entities are called **variable interest entities** (VIEs). The Variable Interest Entities Subsections also provide guidance for determining whether a reporting entity shall consolidate a VIE. A reporting entity that consolidates a VIE is called the **primary beneficiary** of that VIE.

**1.1.20.20.** To achieve its objective, the FASB established in FIN 46(R) a consolidation model for VIEs based primarily on a quantitative evaluation of the economic risks and rewards inherent in the VIE’s assets and liabilities and the way in which the various parties involved with the VIE share those economic risks and rewards. FIN 46(R) defined economic risks and rewards prescriptively and referred to them as expected losses and expected residual returns. It defined
an enterprise that is required to consolidate a VIE as the VIE’s primary beneficiary. The mechanisms or interests through which an enterprise shares in an entity’s economic risks and rewards are called variable interests. The ASC Subtopic 810-10 glossary defines variable interests as “contractual, ownership, or other pecuniary interests in a VIE that change with changes in the fair value of the VIE’s net assets exclusive of variable interests.” Variable interests include, but are not limited to, an entity’s voting stock, loans to an entity, guarantees that an entity will repay its obligations, and rights to purchase a majority of an entity’s assets (based on their fair value) at a strike price other than fair value.

1.1.20.30. An enterprise that does not have a variable interest in an entity cannot be required to consolidate the entity. In addition, an enterprise that has a variable interest in a VIE must evaluate whether to consolidate the entity under the voting control requirements of U.S. GAAP rather than the VIE consolidation requirements if the enterprise qualifies for one of the scope exceptions to the VIE consolidation requirements of ASC Subtopic 810-10.

1.1.20.40. FIN 46(R) did not pre-judge whether voting equity interests in various types of entities fairly or completely reflect the controlling interests in those entities. Instead, it identified characteristics that indicate that the voting interests may not be effective in identifying whether an entity should be consolidated by another enterprise and, if so, which enterprise. For this reason, the VIE consolidation guidance effectively functions as a gateway through which all consolidation decisions must pass. That is, before concluding that it is appropriate to apply the voting interests consolidation model under ASC Subtopic 810-10 (originally issued as Accounting Research Bulletin No. 51, Consolidated Financial Statements) to an entity, an enterprise must first determine that the entity is not subject to the VIE consolidation model established by FIN 46(R).

1.1.20.50. As a consequence of the issuance of FIN 46(R), and before the initial application of subsequent amendments, a reporting enterprise would apply one of the following consolidation models, the applicability of which depends on the characteristics of an entity’s equity and its governance:
1.1.30. Shifting from a Quantitative to a Qualitative Evaluation

1.1.30.10. In 2008, the FASB began a project to enhance the FIN 46(R) VIE consolidation model, which resulted in the issuance of FASB Accounting Standards Update No. 2009-17 (ASU 2009-17), Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities (originally issued as FASB Statement No. 167, Amendments to FASB Interpretation No. 46(R) (Statement 167), in June 2009). ASU 2009-17 changed the FIN 46(R) test for determining the primary beneficiary of a VIE to a qualitative analysis rather than a primarily quantitative analysis, and enhanced the FIN 46(R) disclosure requirements for enterprises involved with VIEs.

1.1.30.20. During the project, the Board decided to also address other concerns about the VIE Subsections of ASC Subtopic 810-10, in the process changing the criteria for determining whether fees paid by an entity to a decision maker or another service provider are a variable interest in the entity, which affects whether the decision maker or service provider is considered the primary beneficiary of the entity if it is a VIE. Under the ASU 2009-17 changes to ASC Subtopic 810-10, an enterprise is required to consolidate a VIE if the enterprise has both (a) the power to direct the activities that most significantly impact the entity’s economic performance (referred to as power) and (b) the obligation to absorb losses of, or the right to receive benefits from, the entity that could potentially be significant to the entity (referred to as a potentially significant variable interest).

1.1.40. Deferral of ASU 2009-17 for Certain Investment Funds

1.1.40.10. After the issuance of ASU 2009-17, representatives of organizations in the asset management industry met with members of the FASB staff to discuss concerns that because of the new criteria used to determine whether a decision
maker’s fee is a variable interest, ASU 2009-17 may require asset managers to consolidate some investment entities that they manage that are considered VIEs, such as certain money market funds, mutual funds, private equity funds, hedge funds, and venture capital funds. The FASB and SEC staffs also discussed with analysts the implications of consolidating funds in the financial statements of asset managers. Analysts generally indicated that important information about the fees earned by asset managers may be obscured in their financial statements if the investment entities that they manage are consolidated. In addition to issues related to asset managers, the IASB and the FASB potentially had different views about how to evaluate whether an enterprise is acting solely as a fiduciary (i.e., whether an enterprise is a principal or an agent). At the time of issuance of ASU 2009-17, the Boards had not yet sufficiently discussed principal and agent relationships in the context of investment funds to determine whether they would reach consistent conclusions as part of their joint consolidation project.

1.1.40.20. In response to these concerns, in February 2010 the FASB issued FASB Accounting Standards Update No. 2010-10 (ASU 2010-10), Amendments for Certain Investment Funds, which indefinitely deferred the consolidation requirements of ASU 2009-17 for interests in entities that have all of the attributes of an investment company as specified in ASC Topic 946, Financial Services--Investment Companies, or for which it is industry practice to apply measurement principles for financial reporting purposes that are consistent with those in ASC Topic 946 for investment companies, provided that certain conditions are met. However, ASU 2010-10 did not defer the disclosure requirements in ASU 2009-17 and, therefore, both public and nonpublic reporting enterprises needed to provide the disclosures included in ASU 2009-17 for all VIEs in which they hold a variable interest, including those VIEs that qualify for the deferral.

1.1.40.30. As a result of the issuance of ASU 2010-10, and before the initial application of ASU 2015-02, a reporting enterprise would apply one of the following consolidation models:
1.1.50. Issuance of ASU 2015-02

1.1.50.10. In November 2011, the FASB issued an exposure draft of proposed consolidation guidance with the primary objective of addressing the concerns expressed by financial statement users about the possibility that the guidance in ASU 2009-17 could require investment managers and similar entities to consolidate certain investment funds that they manage. Another objective of the proposed guidance was to eliminate the inconsistency between how participating rights and kick-out rights are evaluated for VIEs versus other entities. To achieve these objectives, the Board initially proposed a judgmental framework in which the following qualitative factors would be evaluated to determine whether a decision maker or service provider is exercising its decision-making rights in the capacity of a principal or an agent:

- Rights held by other parties;
- Decision maker’s compensation; and
- Decision maker’s other economic interests.

1.1.50.20. Constituents expressed a number of concerns about the complexity of the FASB’s proposals and the lack of clarity about how to weigh the factors in the qualitative analysis. During its redeliberations, the Board decided it could achieve its primary objective through fairly limited changes to the existing consolidation literature. The FASB decided, based on feedback from constituents, that aligning the evaluation of participating rights and kick-out rights for VIEs and other entities was not necessary. The Board concluded that it could accomplish its primary objective mainly by making changes to the criteria that define a VIE and the guidance for evaluating whether a service provider or decision maker’s fee is considered a variable interest that would require the reporting enterprise to consolidate the VIE, including the manner in which interests of related parties
affect those evaluations. The FASB ultimately decided not to develop a separate set of criteria to determine whether a decision maker is functioning in the capacity of a principal or an agent, but rather to integrate that evaluation into the criteria for identifying a controlling financial interest in a VIE. Instead of issuing a revised exposure draft of the 2011 proposed standard, the FASB staff conducted an extended fatal-flaw review process involving a broad range of stakeholders. In response to comments received from the fatal-flaw review process, the Board decided to further revise the VIE criteria, mainly to address concerns about how those criteria would affect certain mutual fund investment structures.

1.1.50.30. The FASB issued ASU 2015-02 in February 2015. The ASU changed the way reporting enterprises evaluate whether (a) they should consolidate limited partnerships and similar entities, (b) fees paid to a decision maker or service provider are variable interests in a VIE, and (c) variable interests in a VIE held by related parties of the reporting enterprise require the reporting enterprise to consolidate the VIE. Given the Board’s decision not to establish separate principal versus agent criteria, the final standard’s title does not refer to principal versus agent guidance. ASU 2015-02 rescinded the indefinite deferral included in ASU 2010-10 and therefore eliminated the VIE consolidation model based on majority exposure to variability that applied to certain investment companies and similar entities. The FASB decided to exclude from the U.S. GAAP consolidation requirements money market funds that are required to comply with Rule 2a-7 of the Investment Company Act of 1940 (the 1940 Act) or that operate under requirements similar to those in Rule 2a-7 of the 1940 Act. The Board also changed the way the voting rights characteristic in the VIE scope determination is evaluated, the analysis of which now depends on whether the entity being evaluated is a limited partnership (or similar entity) or a corporation. ASU 2015-02 was effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2015. The effective date is one year later for all other entities. Early adoption is allowed, including early adoption in an interim period. A reporting enterprise is permitted to apply either a modified retrospective approach or full retrospective application. The transition provisions for adopting ASU 2015-02 are the same as the transition provisions for ASU 2009-17 (see Section 10, Effective Date and Transition).
1.1.50.40. The issuance of ASU 2015-02 results in a single VIE model that applies to all VIEs and a single consolidation model that applies to all voting interest entities as illustrated below:

1.1.60. Issuance of ASU 2016-17

1.1.60.10. In October 2016, the FASB issued ASU 2016-17 to address concerns that because ASU 2015-02 requires a single decision maker, in circumstances involving common control, to attribute interests held by certain of its related parties entirely to itself, the single decision maker may be required to consolidate a VIE even if it has little or no variable interests in the VIE. As a result, the single decision maker may provide financial information that is not useful to users of that information. ASU 2016-17 changes that guidance and instead requires the single decision maker to consider indirect interests held through related parties that are under common control on a proportionate basis. This change will result in the single decision maker considering all indirect interests held through related parties on a proportionate basis regardless of whether it is under common control with the related party.

1.1.60.20. ASU 2016-17 is effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2016. For all other entities, it is effective for annual periods in fiscal year beginning after December 15, 2016, and interim periods in fiscal years beginning after December 15, 2017. Entities that have not adopted ASU 2015-02 should adopt ASU 2016-17 at the same time and apply the same transition method for both standards. Entities that already adopted ASU 2015-02 should apply ASU 2016-17 retrospectively to all periods beginning with the earliest annual period in which they adopted ASU 2015-02. Entities can adopt the ASU immediately, including in an interim period. However, if an entity adopts in an interim period other than the first interim period, it should compute and reflect the cumulative effect of the accounting change as of the beginning of the fiscal year that includes that interim period.
1.1.70. Decision Process That a Reporting Enterprise May Use

1.1.70.10. The following chart depicts a decision process that an enterprise may wish to consider in evaluating whether to consolidate another entity. Each of the steps in the decision process is discussed in further detail in this publication.

Step 1  Step 2  Step 3  Step 4  Step 5

ASU 2015-02 affects the steps in the decision process suggested above as follows:

Step 1  
- It exempts registered money-market funds (MMFs) and similar entities from consolidation under the requirements of ASC Topic 810. Registered MMFs and similar entities are no longer subject to consolidation by their sponsor or any other party involved with them. In addition, parties involved with those entities are no longer subject to the disclosure requirements that apply to VIEs. However, a reporting enterprise is required to disclose financial support that it has
• It eliminates the VIE model based on majority exposure to variability that applied to investment entities eligible for the ASU 2010-10 deferral of ASU 2009-17. A single VIE model applies to all VIEs. This may change the circumstances in which an investment entity that previously was eligible for the deferral of ASU 2009-17 would be consolidated under the new guidance.

• It changes the guidance for determining whether fees paid to a decision maker or service provider are a variable interest in a VIE. It is less likely that such fees will be a variable interest under the new guidance. As a result, it is less likely that the decision maker or service provider will be required to consolidate a VIE that it is involved with.

• It changes the guidance about how to consider the interests of related parties in evaluating whether fees paid to a decision maker or service provider represent a variable interest.

• It establishes new criteria to determine whether the equity-at-risk investors have power to direct the activities that most significantly impact an entity’s economic performance. Some entities previously considered VIEs may now be considered voting interest entities as a result of these changes. If so, this will eliminate the related party considerations that affected consolidation conclusions for those entities and the disclosures that apply to variable interest holders in a VIE.

• For limited partnerships and similar entities, the general partner need not obtain its decision-making rights
through an equity-at-risk investment for the entities to be voting interest entities in the absence of substantive kick-out rights or participating rights over the general partner held by a single equity-at-risk investor or related party group of equity-at-risk investors.

• Corporations (and other entities that are not similar to limited partnerships) that have a decision maker whose fee is a variable interest may qualify as voting interest entities in the absence of substantive kick-out rights or participating rights over the decision maker held by a single equity-at-risk investor or related party group of equity-at-risk investors.

Step 5

• It changes the guidance with respect to the inclusion of fees paid to a decision maker or service provider if certain conditions are met when evaluating whether a reporting enterprise is the primary beneficiary.

• It changes the guidance in evaluating which variable interest holder (if any) in a related party group is the primary beneficiary of a VIE. The changes reduce the effect of related party interests on those evaluations.

1.1.70.30. The likelihood of changes in a company’s consolidation conclusions as a result of ASU 2015-02 depends on the specific facts and circumstances. However, because the likelihood of a change is affected by the types of entities a company is involved with, the following table may help to focus initial application efforts on those entities for which consolidation conclusions are most likely to change under the ASU’s requirements.

<table>
<thead>
<tr>
<th>Type of Entity</th>
<th>Likelihood of Change in Consolidation Conclusion</th>
<th>Observations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Limited partnerships and similar entities (e.g., many LLCs)</td>
<td>High</td>
<td>Limited partnerships that are voting interest entities consolidated by the general partner under ASC Topic 810</td>
</tr>
<tr>
<td>Type of Entity</td>
<td>Likelihood of Change in Consolidation Conclusion</td>
<td>Observations</td>
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<tr>
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<td>before amendment by ASU 2015-02 will become VIEs under the ASU's provisions. Often the general partner may deconsolidate these partnerships because ASU 2015-02's guidance on whether fees represent a variable interest, and interests held by related parties, increases the likelihood that the general partner will be deemed to be acting solely as a fiduciary of the limited partners. Changes in consolidation conclusions also may occur for limited partnerships considered VIEs under ASC Topic 810 before amendment by the ASU because the general partner does not have an equity-at-risk investment when the limited partners have substantive kick-out rights or participating rights that are exercisable by a simple majority of the voting interests held by partners not under common control with the general partner or acting on behalf of the general partner. These entities may become voting interest entities and be deconsolidated by the general partner.</td>
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Corporations  Moderate  Changes in consolidation conclusions may occur for corporations with outsourced managers that were considered VIEs under ASC Topic 810 before amendment by ASU 2015-02. Some of those corporations may qualify as voting interest entities under the ASU’s provisions and, if so, may be deconsolidated by the manager. Those corporations that remain VIEs under the provisions of ASU 2015-02 may be deconsolidated by the manager in some
<table>
<thead>
<tr>
<th>Type of Entity</th>
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<th>Observations</th>
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<td></td>
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<td>Circumstances because the ASU’s guidance on whether fees represent a variable interest, and interests held by related parties, increases the likelihood that the manager will be deemed to be acting solely as a fiduciary of the equity investors. Corporations that are voting interest entities under ASC Topic 810 before amendment by ASU 2015-02 are likely to remain voting interest entities and, therefore, ASU 2015-02 likely will not change consolidation conclusions for those corporations.</td>
</tr>
<tr>
<td>Trusts</td>
<td>Moderate</td>
<td>In general, trusts are likely to remain VIEs under the provisions of ASU 2015-02. However, ASU 2015-02’s guidance on whether fees represent a variable interest, and interests held by related parties, reduces the likelihood that trusts will be required to be consolidated.</td>
</tr>
<tr>
<td>Traditional investment funds</td>
<td>Low</td>
<td>Registered investment companies (including registered series mutual funds) and similar traditional investment funds other than non-registered series mutual funds are likely to be voting interest entities under the provisions of ASU 2015-02 and are not likely to be consolidated unless an investor holds a majority of their investment interests. This is not likely to significantly change prior consolidation conclusions.</td>
</tr>
<tr>
<td>Non-registered series mutual funds (e.g., foreign)</td>
<td>Moderate</td>
<td>ASU 2015-02’s guidance suggests it is possible in some circumstances for non-registered series mutual funds to be considered separate entities at the individual series level for</td>
</tr>
<tr>
<td>Type of Entity</td>
<td>Likelihood of Change in Consolidation Conclusion</td>
<td>Observations</td>
</tr>
<tr>
<td>--------------------------------------</td>
<td>--------------------------------------------------</td>
<td>-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Alternative investment funds</td>
<td>Moderate</td>
<td>In general, alternative investment funds that are VIEs under ASC Topic 810 before amendment by ASU 2015-02 are likely to remain VIEs under the provisions of ASU 2015-02. However, the ASU’s guidance on whether fees represent a variable interest, and interests held by related parties, reduces the likelihood that these entities will be required to be consolidated. Funds with managers over which there are substantive (but not unilateral) kick-out rights or participating rights may qualify as voting interest entities under the provisions of ASU 2015-02 and, if so, may be deconsolidated by the manager. Funds that are voting interest entities under ASC Topic 810 before amendment by ASU 2015-02 are likely to remain voting interest entities and, therefore, the ASU likely will not change consolidation conclusions for those entities.</td>
</tr>
<tr>
<td>Structured investment vehicles (e.g., CDOs, CLOs, commercial paper conduits, etc.)</td>
<td>Moderate</td>
<td>In general, structured investment vehicles are likely to remain VIEs under the provisions of ASU 2015-02. However, ASU 2015-02’s guidance on whether fees represent a variable interest, and interests held by related parties, reduces the likelihood that consolidation purposes rather than the umbrella trust level. Changes in consolidation conclusions may occur when the manager of the series also holds a majority of the individual series’ investment interests (e.g., in a seed capital stage).</td>
</tr>
</tbody>
</table>
### Type of Entity

<table>
<thead>
<tr>
<th>Type of Entity</th>
<th>Likelihood of Change in Consolidation Conclusion</th>
<th>Observations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Segregated (protected) cell companies</td>
<td>Moderate</td>
<td>ASU 2015-02’s guidance suggests it is possible in some circumstances for these structures to be considered separate entities at the individual cell level for consolidation purposes rather than the umbrella company level. Whether the individual cells are considered VIEs and whether they should be consolidated by their decision maker may change in those circumstances. For segregated cell companies that remain VIEs under the provisions of ASU 2015-02, the ASU’s guidance on whether fees represent a variable interest, and interests held by related parties, reduces the likelihood that the entities will be required to be consolidated.</td>
</tr>
</tbody>
</table>

### 1.2. SUBSTANTIVE TERMS, TRANSACTIONS, AND ARRANGEMENTS

#### 1.2.10. Application to All Aspects of VIE Analyses

**1.2.10.10.** ASU 2009-17 included language requiring that only substantive terms, transactions, and arrangements (whether contractual or noncontractual) be considered when applying the VIE guidance of ASC Subtopic 810-10, as indicated in ASC paragraphs 810-10-15-13A and 15-13B. This substance requirement applies to all aspects of VIE analyses, including evaluation of the consolidation and disclosure requirements, and underscores the need to consider qualitative factors in addition to quantitative factors when applying the VIE provisions of ASC Subtopic 810-10.

**1.2.10.20.** ASU 2015-02 retains the substance requirement included in ASU 2009-17 and further clarifies that the purpose and design of a legal entity must be considered when performing this assessment.
Excerpt from ASC 810-10

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

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

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

1.2.10.30. At the 2010 AICPA National Conference on Current SEC and PCAOB Developments, a member of the SEC staff highlighted ASU 2009-17’s shift toward a more qualitative model. An excerpt from the speech follows:

Excerpt from Speech by Paul A. Beswick

I would like to spend a couple of minutes talking about our experiences in OCA with the consolidation model for variable interest entities in ASC Topic 810, or Statement 167 if you like. The FASB has taken a more principles based approach that requires qualitative-based judgments in determining whether consolidation of a variable interest entity is required. Simply put, the principle is that a reporting entity has a controlling financial interest in an entity if it has both the power to direct the activities of the entities and rights/obligations that potentially could be significant. I think this is important to highlight because during this first year of adoption, we have encountered those who were hanging on to the quantitative approach in FIN 46(R), rather than focusing on the qualitative model of Statement 167.

1.2.10.40. Another member of the SEC staff also commented on the linkage between the consideration of qualitative factors and the substance requirements of ASU 2009-17 in a speech at the 2010 AICPA National Conference on Current SEC and PCAOB Developments. An excerpt from the speech follows:
Excerpt from Speech by Wesley R. Bricker

To sum it up, a great way to know that your qualitative judgments within the model are sound is to ensure that your conclusions are supported by the facts and substance of the arrangement and by a well-reasoned, common sense application of the literature.

1.2.20. Factors to Consider in Substance Requirements

**Question 1.2.20.1: Factors to Consider in Evaluating Whether Terms, Transactions, and Arrangements Are Substantive**

What factors should be considered in evaluating whether terms, transactions, and arrangements are substantive for purposes of applying the VIE guidance of ASC Subtopic 810-10?

**Interpretive Response:** The FASB included the guidance in ASC paragraphs 810-10-15-13A and 15-13B to avoid situations in which the form of an entity might indicate that the entity is not a VIE or a reporting enterprise is not a primary beneficiary when the substance of the arrangement indicates otherwise. The FASB did not intend for that guidance to imply that nonsubstantive terms should be considered in other areas of U.S. GAAP. While the language in ASC paragraphs 810-10-15-13A and 15-13B does not preclude restructuring of existing arrangements, it emphasizes the Board’s expectation “that any restructuring of existing entities, contracts, or agreements to avoid consolidating entities under [ASC Subtopic 810-10] would be done in a substantive manner that truly changes the enterprise’s power and/or obligations to absorb losses or right to receive benefits.”

Professional judgment is required to determine whether terms, transactions, and arrangements are substantive. In general, it is expected that substantive terms, transactions, and arrangements have been designed to achieve specific business objectives other than a particular accounting outcome and affect the economic considerations of the parties involved. For enterprises planning to change arrangements, it is important to consider whether the revised arrangements affect the economic position of the affected parties in a manner that is commensurate with those changes. The evaluation of whether a particular arrangement is substantive should be the same for both new and restructured arrangements that existed before the adoption of ASU 2015-02. The SEC staff has indicated informally that it expects these substance provisions to be broadly applied. The following example illustrates these concepts.

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3 Paragraph A5 of Statement No. 167.
4 Paragraph A109 of Statement 167.
Example 1.2.20.1: Restructuring of Commercial Paper Conduit

Assume that a multi-seller commercial paper conduit structure was formed in 1998. Multiple parties transfer trade receivables to the conduit (a special-purpose entity) and the conduit issues commercial paper of various durations on a rolling basis to fund the purchase of the receivables. The conduit also issued a small amount of long-term subordinated Class C notes that are held by the sponsor, who acts as the conduit’s administrator. The conduit meets the ASC Subtopic 810-10 criteria to be a VIE and no scope exceptions are applicable. Before the effective date of ASU 2009-17, the conduit issued expected-loss notes (ELNs) that were designed to absorb a majority of the conduit’s expected losses. The ELNs are held by a hedge fund domiciled in Bermuda. The Class C notes are senior only to the ELNs. Under ASC Subtopic 810-10, and before the effective date of ASU 2009-17 (unamended ASC 810-10), the sponsor was not the primary beneficiary of the conduit because it does not absorb a majority of the expected losses or receive a majority of the expected residual returns of the conduit. Before ASU 2009-17’s adoption, the sponsor restructured the legal agreements to grant the ELN holder the unilateral ability to remove the sponsor without cause. At the time of the restructuring there were no corresponding changes in the economic arrangements between the conduit’s variable interest holders (including the sponsor and the ELN holder). In view of the following facts, we believe the rights granted to the Bermuda hedge fund to unilaterally kick out the sponsor would be considered nonsubstantive and would be disregarded in applying ASC Subtopic 810-10:

- The ELN holder previously had a more limited set of rights and did not provide equivalent consideration to the sponsor in exchange for the kick-out rights received,
- The ELN holder would not be expected to have deep expertise with respect to the administration of commercial paper conduits, and
- There is no specific business objective for the sponsor that is achieved by providing kick-out rights to the ELN holder other than attempting to achieve a particular accounting result.

If the conduit were newly established after the issuance of ASU 2009-17 with terms as described above (i.e., the ELN holder had kick-out rights over the sponsor), and the economic arrangements between the conduit’s variable interest holders (including the sponsor and the ELN holder) were substantially the same as those for the conduit established in 1998, we believe the conclusion about the kick-out rights would be the same as for the modified conduit in this example.
2. Scope

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2.1 APPLICATION TO LEGAL ENTITIES

2.1.10 Overview

Excerpts from ASC Subtopic 810-10

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

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

15-9 A majority-owned subsidiary is an entity separate from its parent and may be a variable interest entity (VIE) that is subject to consolidation in accordance with the Variable Interest Entities Subsections of this Subtopic. Therefore, a reporting entity with an explicit or implicit interest in a legal entity within the scope of the Variable Interest Entities Subsections shall follow the guidance in the Variable Interest Entities Subsections.

15-15 Portions of legal entities or aggregations of assets within a legal entity shall not be treated as separate entities for purposes of applying the Variable Interest Entities Subsections unless the entire entity is a VIE. Some examples are divisions, departments, branches, and pools of assets subject to liabilities that give the creditor no recourse to other assets of the entity. Majority-owned
subsidiaries are legal entities separate from their parents that are subject to the Variable Interest Entities Subsections and may be VIEs.

**25-59 Acquisition, development, and construction loan structures** may be VIEs subject to the guidance in the Variable Interest Entities Subsections. Guidance on determining whether a lender should account for an acquisition, development, and construction arrangement as a loan or as an investment in real estate or a joint venture is presented in Subtopic 310-10.

**20 Glossary**

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

**2.1.10.10.** The VIE provisions of ASC Subtopic 810-10, *Consolidation – Overall*, generally apply to all legal entities. Even legal entities to which some of the scope exceptions apply are not entirely excluded from the application of the VIE provisions of this subtopic in certain circumstances. Furthermore, the application is not limited to specific industries (e.g., the financial services industry) and the nature of the activities or assets held or used in the arrangement is not relevant to the evaluation of whether the structure is a legal entity subject to ASC Subtopic 810-10. So-called virtual entities or portions of entities are not subject to the VIE provisions of ASC Subtopic 810-10 unless the entire legal entity is a VIE. As discussed in Section 5, *Silos*, a portion of a VIE’s assets, related liabilities, and other interests (such as guarantees and purchase options) is evaluated as a separate legal entity only if the VIE’s contractual arrangements economically isolate those assets, liabilities, and other interests. In practice, such economically isolated assets, liabilities, and other interests are referred to as silos.

**2.1.10.20.** Legal entities that are majority- or wholly-owned by an enterprise are subject to the VIE provisions of ASC Subtopic 810-10, regardless of whether they are consolidated by the enterprise, because the scope of the VIE provisions of ASC Subtopic 810-10 does not depend on an entity’s consolidation status. In some situations, the sole or majority owner of an investee may not consolidate the investee if it is a VIE. This could happen, for example, when another party has power through a contractual arrangement to direct the activities that most significantly affect the investee’s economic performance and an economic interest that either obligates or entitles that party to absorb losses of, or receive benefits from, the investee that could potentially be significant to the investee. In addition, even if an investor is required to consolidate a majority- or wholly-owned investee that is a VIE, determining whether the entity is a VIE is necessary because disclosure requirements differ for subsidiaries that are VIEs as opposed to those that are not VIEs. See Section 9, *Presentation and Disclosure*, for additional guidance on the disclosure requirements that apply to VIEs.
2.1.20 Example Legal Entities Subject to ASC Subtopic 810-10

2.1.20.10. Examples of legal entities that are subject to the provisions of ASC Subtopic 810-10 include, but are not limited to, corporations, limited partnerships, general partnerships, limited liability limited partnerships, limited liability companies, trusts, and individual series mutual funds required to comply with the Investment Company Act of 1940. Arrangements in which such entities may be used and may need to be evaluated for consolidation under the VIE provisions of ASC Subtopic 810-10 include, but are not limited to:

- Joint ventures;
- Product and inventory financing arrangements;
- Vendor financing arrangements;
- Research and development ventures;
- Collaborative arrangements;
- Outsourcing arrangements;
- Leasing arrangements:
  - Operating leases with purchase options, residual value guarantees, fixed-price renewal options, or similar features;
  - Capital leases;
  - Build-to-suit arrangements;
  - Synthetic leases;
  - Leveraged leases; and
  - Sale-leasebacks;
- Franchise arrangements;
- Insurance and reinsurance arrangements;
- Residential and commercial construction arrangements:
  - Lot option arrangements;
- Energy arrangements:
  - Capacity purchase agreements;
  - Wind or solar farms; and
  - Synthetic fuel partnerships;
- Securitization and similar arrangements:
  - Residential mortgage securitizations;
  - Commercial mortgage securitizations;
  - Credit card securitizations;
• Collateralized debt obligations;
• Collateralized loan obligations;
• Collateralized bond obligations;
• Commercial paper conduits;
• Enhanced Equipment Trust Certificates; and
• Trust preferred securities;
• Investment arrangements:
  • Mutual funds;
  • Hedge funds;
  • Venture capital funds;
  • Private equity funds; and
  • Real estate funds, including affordable housing partnerships.

Question 2.1.20.1: Fiduciary and Other Accounts Not Held by the Reporting Enterprise

Are fiduciary accounts for assets held in trust (i.e., not in a separate legal entity) subject to the VIE consolidation provisions of ASC Subtopic 810-10 because they are considered to be legal structures?

Interpretive Response: The VIE consolidation provisions of ASC Subtopic 810-10 only apply to legal entities (as defined in ASC Section 810-10-20). If assets held in trust are held on behalf of others but not in a separate legal entity, the VIE consolidation provisions of ASC Subtopic 810-10 do not apply to the fiduciary accounts.

Question 2.1.20.2: Collaborative Arrangements Established by Contract

Do the VIE consolidation provisions of ASC Subtopic 810-10 apply to collaborative arrangements (between entities) that are established by contract but are not conducted through a separate legal entity?

Interpretive Response: Generally no. The VIE consolidation provisions of ASC Subtopic 810-10 generally only apply to legal entities (see definition in ASC Section 810-10-20 above). For a collaborative arrangement that is not conducted using a separate legal entity, the VIE consolidation provisions of ASC Subtopic 810-10 do not apply. ASC Subtopic 808-10, Collaborative Arrangements - Overall, includes the following examples of collaborative arrangements. The VIE consolidation provisions of ASC Subtopic 810-10 do not apply to these arrangements because the activity is not conducted through a separate legal entity. However, if the parties formed a separate legal entity to conduct the collaboration activities, those parties would need to evaluate
whether to consolidate the entity, which would entail first determining whether it is a VIE within the scope of the VIE consolidation provisions of ASC Subtopic 810-10.

Excerpts from ASC Subtopic 808-10

55-2 For the purpose of the Examples in this Section, assume that all of the arrangements are collaborative arrangements within the scope of this Topic.

Example 1: Equal Participation in Results of Research, Development, and Commercialization Arrangement, Participants Perform Different Activities

55-3 This Example illustrates the guidance in Section 808-10-45. Pharma and Biotech agree to equally participate in the results of research and development activities for a drug candidate and in the commercialization activities if and when the drug candidate is approved for sale, pursuant to a joint development and marketing agreement (a 50 percent, 50 percent arrangement). Biotech is responsible for conducting research and development activities relating to the drug candidate, and Pharma is responsible for the commercialization activities if and when the drug candidate is approved for sale. On a quarterly basis, Pharma and Biotech provide the other party financial information about the research and development activities performed by Biotech and the commercialization activities performed by Pharma under the joint development and marketing agreement. One participant is required to make a payment to the other participant for the proportionate share of the excess of the entities’ combined operating results pursuant to their joint development and marketing agreement.

Example 2: Equal Participation in Results of Research, Development, and Commercialization Arrangement, Participants Perform Some of the Same Activities

55-7 This Example illustrates the guidance in Section 808-10-45. Pharma and Biotech agree to equally participate in the results of research and development activities for a drug candidate and in the commercialization activities if the drug candidate is approved for sale, pursuant to a joint development and marketing agreement (a 50 percent, 50 percent arrangement). Assume that Pharma and Biotech both agree to provide resources during the research and development phase, and Pharma is responsible for the commercialization activities if the drug candidate is approved for sale. As both participants are performing research and development activities, there may be periods in which Biotech must make a payment to Pharma for its proportionate share of the research and development activities and periods in which Pharma must make payments to Biotech. On a quarterly basis, Pharma and Biotech provide financial information about the research and development activities performed by both parties and the commercialization activities performed by Pharma under the joint development and marketing agreement. One participant is required to make a payment to the other participant for a proportionate share of the excess
of the parties’ combined operating results pursuant to their joint development and marketing agreement.

**Example 3: Unequal Participation in Results of Research, Development, and Commercialization Arrangement, Participants Perform Some of the Same Activities**

55-11 This Example illustrates the guidance in Section 808-10-45. Big Pharma and Little Pharma agree to jointly participate in the results of the research and development activities for a drug candidate and in the commercialization activities if and when the drug candidate is approved for sale, pursuant to a joint development and marketing agreement. Big Pharma and Little Pharma both agree to provide resources during the research and development and the commercialization activities. Little Pharma will be responsible for commercialization activities in the United States, and Big Pharma will be responsible for commercialization activities in Europe and Asia. Under the arrangement, they will share research and development costs incurred on a 50 percent, 50 percent basis. Little Pharma will retain 65 percent of the net profits from commercialization activities in the United States, and Big Pharma will retain 70 percent of the net profits from commercialization activities in Europe and Asia. On a quarterly basis, Big Pharma and Little Pharma provide financial information about the research and development and the commercialization activities performed by both parties under the joint development and marketing agreement, and one participant is required to make a payment to the other participant for a proportionate share of the excess of the parties’ combined operating results pursuant to their joint development and marketing agreement.

**Example 4: Equal Participation in Results of Production and Distribution of Major Motion Picture, Participants Perform Some of the Same Activities**

55-15 This Example illustrates the guidance in Section 808-10-45. Studio A and Studio B agree to jointly participate in the production and distribution of a major motion picture. Studio A will manage the day-to-day production activities and will be responsible for distribution in the United States. Studio B will be responsible for distribution in Europe and Asia. Even though Studio A will be managing the production, the terms of the arrangement state that both studios will share equally in all production costs incurred. Further, Studio A will pay 50 percent of the net profits (that is, revenues less distribution costs) from the United States distribution to Studio B, and Studio B will pay 50 percent of the net profits from European and Asian distribution to Studio A. The studios are responsible for initially funding all distribution costs in their respective locations. For purposes of this example, no license to intellectual property has been conveyed to Studio B.
Question 2.1.20.3: Portions of Legal Entities

Why are “[p]ortions of legal entities or aggregations of assets within a legal entity” (i.e., silos), as described in ASC paragraph 810-10-15-15, sometimes considered separate entities when applying the VIE guidance in ASC Subtopic 810-10?

Interpretive Response: As discussed further in Section 5, to avoid dissimilar accounting for economically similar arrangements, the FASB’s Emerging Issues Task Force created the notion of silos in its guidance addressing whether a lessee should consolidate a special-purpose lessor entity. The EITF concluded that the use of nonrecourse debt with no cross-collateral provisions effectively segregated the cash flows and assets associated with multiple leases and, in substance, created multiple special-purpose entities (SPEs) or silos that should be separately evaluated for consolidation when certain conditions were met. The ASC Subtopic 810-10 reference to portions of legal entities or aggregations of assets within a legal entity relates to the concept of virtual SPEs (divisions, departments, branches, and pools of assets subject to liabilities that provide the creditor recourse only to the specified assets), which are not separate legal structures from the entity that holds title to the assets and are therefore excluded from the scope of ASC Subtopic 810-10. The FASB included this concept in the VIE consolidation guidance for the same reasons that the EITF included it in the EITF literature – to avoid allowing similar arrangements to be accounted for differently.

For example, a lessor enterprise may have a choice of how to structure a lease. It may own various leased assets directly and obtain a loan with recourse only to a specific leased property. Alternatively, the lessor enterprise may establish a separate, legally-isolated, entity to hold the specified leased asset and obtain the related financing. That separate entity may be so thinly capitalized that it is a VIE. If so, the entity might be consolidated by a party other than the lessor enterprise (e.g., the lessee), depending on the lease terms. However, if the lessor enterprise had more than nominal equity capital that was at-risk to all of its assets, a party other than the lessor would not consolidate the specified asset if the lessor enterprise held it directly and leased other assets representing at least half of the fair value of its assets to unrelated lessees because the lessor’s assets would not be economically isolated from each other. Conversely, if portions of the lessor were economically isolated from each other (e.g., through a capital structure consisting of targeted equity and nonrecourse debt to specific assets), the FASB concluded that the economic effect is substantively the same as placing the respective portions of the lessor in separate legal entities and the consolidation literature should be applied as though there were separate legal entities. See Section 5 for additional information about how to evaluate whether portions of a legal entity have been economically isolated from each other.
**Question 2.1.20.4: Determining Whether a Registered Series Mutual Fund Is a Legal Entity**

Does an individual series mutual fund that is required to comply with the Investment Company Act of 1940 for registered mutual funds meet the definition of a legal entity for purposes of the consolidation guidance in ASC Topic 810?

**Background:** A registered series mutual fund is a type of mutual fund typically organized as a virtual entity within an umbrella legal entity (often organized as a Delaware master trust). The umbrella legal entity typically has multiple series mutual funds within it and a single board of trustees. The investment interests of each series mutual fund participate in the risks and returns of the individual series but none of the other series within the umbrella trust. Consequently, each series mutual fund is isolated economically from all of the other series mutual funds within the umbrella trust.

In practice, before issuance of FASB Accounting Standards Update No. 2015-02 (ASU 2015-02), *Amendments to the Consolidation Analysis*, series mutual funds generally were not considered legal entities under the definition in ASC Topic 810. Consequently, a consolidation analysis for an individual series fund would only be performed if the umbrella trust was considered a VIE. Before issuance of ASU 2015-02, there was diversity in practice with respect to how to determine whether an umbrella trust in a series mutual fund arrangement was a VIE (see Question 4.2.30.2). Where the umbrella trust was not considered a VIE, there was no consolidation analysis performed for the individual series mutual funds because to consolidate an individual series as a silo, the umbrella trust must be a VIE. (For additional guidance on evaluating whether to consolidate silos within a single legal entity, see Section 5.)

**Interpretive Response:** Yes. The FASB decided that it was reasonable to consider an individual registered series mutual fund to be a separate legal entity. The ASC Master Glossary definition of legal entity is:

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

In paragraphs BC38 and BC39 of the ASU, the Board explained that it was reasonable to treat individual registered series mutual funds as legal entities because "[e]ach individual series fund that is required to comply with the Investment Company Act of 1940 for registered mutual funds:

(a) Has its own investment objectives and policies.
(b) Has its own custodial agreement.
(c) Has its own shareholders separate from other series funds.
(d) Has a unique tax identification."
(e) Files separate tax returns with the Internal Revenue Service.
(f) Has separate audited financial statements.
(g) Is considered a separate investment company in virtually all circumstances for purposes of investor protection afforded by the Investment Company Act of 1940 by the Securities and Exchange Commission (SEC) staff’s Division of Investment Management (IM) in accordance with the June 2014 SEC IM staff’s Guidance Update No. 2014-06 titled ‘Series Investment Companies: Affiliated Transactions.’”

Considering individual registered series mutual funds to be legal entities generally will represent a change in practice. However, if the umbrella trust that hosted an individual series mutual fund was considered a VIE, the series fund would have been separately evaluated for consolidation as a silo VIE even before the adoption of ASU 2015-02.

**Question 2.1.20.5: Determining Whether a Structure That Is Economically Similar to a Registered Series Mutual Fund Is a Legal Entity**

Is a structure that is economically similar to a registered series mutual fund considered a legal entity under the definition in ASC Topic 810?

**Background:** There are other structures that are designed to function in a manner that is highly similar to registered series mutual funds as described in Question 2.1.20.4. These structures, which may be organized within the United States, but often are domiciled outside of the United States, include but are not limited to international series trusts and segregated or protected cell companies. In general, these structures are designed to economically isolate groups of assets, liabilities, and related equity interests for investment or other purposes within an umbrella legal entity.

**Interpretive Response:** It depends. If a legal structure has the applicable characteristics described in paragraph BC38 of the ASU (see Question 2.1.20.4), we understand it would be considered a legal entity under the definition in ASC Topic 810. This may represent a change in practice. However, if the umbrella entity that hosted an individual series structure was considered a VIE, the series structure would have been separately evaluated for consolidation as a silo VIE even before the adoption of ASU 2015-02. Also see Question 4.2.30.2. We understand that when an individual series structure is economically isolated from the rest of the umbrella entity and its investors have the power to direct the activities that most significantly impact its economic performance, the SEC staff believes this is an indication that it may be appropriate to consider the individual series structure to be a separate legal entity.
2.2 CONSOLIDATION GUIDANCE SCOPE EXCEPTIONS

2.2.10. Overview

Excerpt from ASC Subtopic 810-10

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

(a) An employer shall not consolidate an employee benefit plan subject to the provisions of Topic 712 or 715.

(b) Subparagraph superseded by ASU 2009-16

(c) Subparagraph superseded by ASU 2009-16

(d) Except as discussed in paragraph 946-810-45-3, an investment company within the scope of Topic 946 shall not consolidate an investee that is not an investment company.

(e) A reporting entity shall not consolidate a governmental organization and shall not consolidate a financing entity established by a governmental organization unless the financing entity meets both of the following conditions:

(1) Is not a governmental organization

(2) Is used by the business entity in a manner similar to a VIE in an effort to circumvent the provisions of the Variable Interest Entities Subsections.

(f) A reporting entity shall not consolidate a legal entity that is required to comply with or operate in accordance with requirements that are similar to those included in Rule 2a-7 of the Investment Company Act of 1940 for registered money market funds.

(1) A legal entity that is not required to comply with Rule 2a-7 of the Investment Company Act of 1940 qualifies for this exception if it is similar in its purpose and design, including the risks that the legal entity was designed to create and pass through to its investors, as compared with a legal entity required to comply with Rule 2a-7.

(2) A reporting entity subject to this scope exception shall disclose any explicit arrangements to provide financial support to legal entities that are required to comply with or operate in accordance with requirements that are similar to those included in Rule 2a-7, as well as any instances of such support provided for the periods presented in the performance statement. For purposes of applying this disclosure requirement, the types of support that should be considered include, but are not limited to, any of the following:
2.2.10.10. An enterprise should evaluate first whether the enterprise or entity qualifies for a consolidation guidance scope exception to the consolidation provisions of ASC Subtopic 810-10. If the enterprise or the entity qualifies for one or more of those consolidation guidance scope exceptions, then the enterprise is not required to apply the consolidation provisions of ASC Subtopic 810-10 but instead is subject to other U.S. GAAP requirements as applicable. If neither the enterprise nor the entity qualifies for one or more of the consolidation guidance scope exceptions to the consolidation provisions of ASC Subtopic 810-10, then the enterprise must evaluate whether the enterprise or entity qualifies for a scope exception to the VIE provisions of ASC Subtopic 810-10 as discussed further in Subsection 2.3.

2.2.10.20. An enterprise should carefully evaluate the consolidation guidance scope exceptions because the entities to which the consolidation guidance scope exceptions apply are not exempt from the consolidation provisions of ASC Subtopic 810-10 under all circumstances.

2.2.10.30. The following flowchart summarizes the scope exceptions from the consolidation guidance, which are further discussed in this Subsection.
2.2.20. Employee Benefit Plans

2.2.20.10. Employers that sponsor employee benefit plans that are accounted for under ASC Subtopic 715-30, Compensation--Retirement Benefits - Defined Benefit Plans—Pension, ASC Subtopic 715-60, Compensation--Retirement Benefits - Defined Benefit Plans--Other Postretirement, and ASC Subtopic 712-10, Compensation--Nonretirement Postemployment Benefits - Overall, should not
Consolidation and Variable Interest Entities, Section 2

The FASB intended the VIE provisions of ASC Subtopic 810-10 to address consolidation issues related to voting control. This scope exception was necessary to maintain that objective. A reconsideration of employers’ accounting for employee benefit plans under ASC Subtopics 715-30, 715-60, and 712-10, would have significantly expanded the reach of the guidance beyond what the FASB wanted to accomplish. The FASB indicated that it does not intend for the VIE consolidation requirements of ASC Subtopic 810-10 to supersede the guidance for accounting by employee benefit plans, including the guidance in ASC Topic 960, Plan Accounting—Defined Benefit Pension Plans. Accordingly, we do not believe that an employee benefit plan should apply the consolidation requirements of ASC Subtopic 810-10 to determine whether to consolidate its investees.

Question 2.2.20.1: Employee Benefit Plans Outside the Scope of ASC Topics 712 or 715

Does the scope exception for employee benefit plans in ASC subparagraph 810-10-15-12(a) apply only to plans that are accounted for under ASC Subtopics 715-30, 715-60, and 712-10?

Interpretive Response: No. We understand from discussions with the FASB staff that the Board intended the scope exception in ASC subparagraph 810-10-15-12(a) also to apply to employers’ accounting for trusts used in funding health and welfare benefit plans, even though these entities are not included in the scope of ASC Topics 712 or 715. Health and welfare benefit plans may segregate and legally restrict assets intended to pay all or part of the covered benefits by establishing an irrevocable, bankruptcy-remote Voluntary Employees’ Beneficiary Association (VEBA or 501(c)(9) trust). Employers often contribute cash to a VEBA trust to cover the short-term lag in their incurred but not reported claims. Contributions made to these trusts generally are tax deductible for the sponsoring employer at the date of funding. AICPA Audit and Accounting Guide, Audits of Employee Benefit Plans, requires employers to account for those trusts in the context of the related plan based on the underlying measurement concepts of ASC Subtopics 715-60 and 712-10. We believe it may also be appropriate to apply the ASC subparagraph 810-10-15-12(a) scope exception by analogy to employee benefit plan entities other than those described above, such as leveraged employee stock ownership plans that are accounted for under ASC Topic 718, Compensation—Stock Compensation.

Question 2.2.20.2: Rabbi Trusts

Is a rabbi trust subject to the VIE provisions of ASC Subtopic 810-10?

Interpretive Response: Yes. A rabbi trust is a legal entity generally used to protect funded deferred employee compensation benefits from loss as a result of certain events other than bankruptcy of the employer (reporting enterprise).
A rabbi trust is not an employee benefit plan and it does not qualify for any of the other scope exceptions to the VIE provisions of ASC Subtopic 810-10 described in Subsection 2.3.

A rabbi trust generally has no equity and typically has a liability to the employees to whom the deferred compensation benefits are owed. As a result, a rabbi trust generally will be a VIE. Even if a rabbi trust does have equity, it generally will be a VIE because the equity investment is not at risk under the provisions of ASC subparagraph 810-10-15-14(a)(3), and the employer provided the equity investment to the employee. The employer (reporting enterprise) should evaluate whether to consolidate a rabbi trust that is a VIE under the VIE consolidation requirements of ASC Subtopic 810-10. If the employer does not meet the conditions to consolidate the rabbi trust (see Section 6, Primary Beneficiary Determination and Reconsideration), the employer should perform an evaluation under ASC Topic 860, Transfers and Servicing, to determine whether the financial assets transferred to the rabbi trust should be derecognized by the employer. If a rabbi trust is not a VIE, it should be consolidated by the employer under ASC Section 710-10-45.

2.2.30. Investments Accounted For At Fair Value

2.2.30.10. The scope exception in ASC subparagraph 810-10-15-12(d) was included by the FASB primarily to ensure that there was no conflict between the consolidation requirements of ASC Subtopic 810-10 and SEC financial reporting regulations (principally the Investment Company Act of 1940). Under the ASC subparagraph 810-10-15-12(d) scope exception, a reporting enterprise that meets the criteria of ASC Topic 946, Financial Services--Investment Companies, to be considered an investment company does not apply the consolidation provisions of ASC Subtopic 810-10 to entities that it is required to measure at fair value in its financial statements. The scope exception does not exclude from the VIE provisions of ASC Subtopic 810-10 an investee (including another investment company) that is a VIE and is not measured at fair value by a reporting enterprise that is itself an investment company. The scope exception also does not include an investment company that has an investment in an operating entity that provides services to the investment company, for example, an investment adviser or transfer agent (see ASC paragraph 946-10-55-5). In those scenarios, the purpose of the investment is to provide services to the investment company rather than to realize a gain on the sale of the investment. If an investment company holds a controlling financial interest in such an operating entity, the investment company should consolidate that investee, rather than measuring the investment at fair value.

2.2.30.20. After the FASB issued ASU 2009-17, Financial Services--Investment Companies, the Board issued Accounting Standards Update No. 2010-10 (ASU 2010-10), Amendments for Certain Investment Funds, to address concerns from organizations in the asset management industry (see paragraph 1.1.40.10 for additional discussion). ASU 2010-10 indefinitely deferred the consolidation requirements of ASU 2009-17 for interests in entities that have all of the
attributes of an investment company as specified in ASC Topic 946, or for which it is industry practice to apply measurement principles for financial reporting purposes that are consistent with those in ASC Topic 946 for investment companies, provided that certain conditions are met. ASU 2010-10 did not defer the disclosure requirements of ASU 2009-17 and, therefore, both public and nonpublic reporting enterprises were required to provide the disclosures included in ASU 2009-17 for all VIEs in which they hold a variable interest, including those VIEs that qualified for the deferral. ASU 2015-02 eliminated this deferral so that the same VIE consolidation requirements apply to all VIEs. Reporting enterprises will no longer evaluate consolidation for these entities when they are VIEs based on majority exposure to variability. See also Subsection 2.2.50 for a discussion of registered money market funds.

2.2.30.30. The scope exception in ASC subparagraph 810-10-15-12(d) does not mean that investment companies cannot themselves be VIEs. If an investment company is a VIE (e.g., because the investors’ interests are not considered U.S. GAAP equity at risk), all parties that are involved with it should consider whether consolidation of the investment company or disclosure of their variable interest(s) in it is required under the provisions of ASC Subtopic 810-10.

Question 2.2.30.1: Investment Companies

Does the scope exception in ASC subparagraph 810-10-15-12(d) preclude an entity that is an investment company subject to ASC Topic 946 from being considered a VIE?

Interpretive Response: No. ASC subparagraph 810-10-15-12(d) provides a scope exception that precludes entities subject to ASC Topic 946 from consolidating VIEs for which ASC Topic 946 requires an investment in the VIE to be measured at fair value. ASC subparagraph 810-10-15-12(d) does not, however, indicate that an entity that is subject to ASC Topic 946 cannot be a VIE. If an entity subject to ASC Topic 946 is a VIE, parties that are involved with it should apply the VIE provisions of ASC Subtopic 810-10 to determine whether to consolidate the entity or to disclose their involvement with the entity. For example, if an investment company fund meets the conditions to be a VIE, the fund advisor would need to evaluate whether it is the primary beneficiary or whether it has a significant variable interest that would require it to disclose its involvement with the fund. Also see Question 2.2.30.2. See Sections 3, Variable Interests, and 6 for additional discussion about the effect of fees paid to a decision maker or service provider (such as a fund advisor) on the determination of the primary beneficiary.
Question 2.2.30.2: Business Development Companies

Does an investment advisor reporting enterprise that makes investment decisions and provides other operating services to a business development company (BDC), subject to the provisions of Section 6-03(c)(1) of SEC Regulation S-X, Rule 6-03, Special Rules of General Application to Registered Investment Companies, need to evaluate whether the BDC is a VIE?

Interpretive Response: Yes, the investment advisor entity must evaluate whether the BDC is a variable interest entity. ASC subparagraph 810-10-15-12(d) provides a scope exception that prohibits consolidation of VIEs for which the SEC rule requires fair value measurement of the investments in the VIEs. It does not, however, indicate that an entity that is subject to the SEC rule cannot itself be a VIE. For example, BDC Co. is required to measure its investments in VIEs at fair value under Rule 6-03(c)(1) and the scope exception in ASC subparagraph 810-10-15-12(d) applies to those investments. However, BDC Co.’s investment advisor, Advisor Co., must evaluate whether it has a variable interest in BDC Co. and, if so, whether BDC Co. is a VIE that Advisor Co. should evaluate for consolidation under the VIE provisions of ASC Subtopic 810-10. Therefore, if an entity subject to the SEC rule is a VIE, parties that have involvement with it should apply the VIE consolidation requirements in ASC Subtopic 810-10 to determine whether to consolidate the entity.

2.2.40. Governmental Organizations

2.2.40.10. ASC Subtopic 810-10 provides a specific exclusion for governmental organizations or financing entities established by governmental organizations. Absent this scope exception, governmental organizations would be considered VIEs due to their lack of equity at risk. The FASB did not intend that outcome for organizations that are subject to accounting standards promulgated by the Federal Accounting Standards Advisory Board (FASAB) or the Governmental Accounting Standards Board (GASB), because the FASB lacks authority to establish accounting standards for those organizations. In addition, the FASB noted that enterprises that obtain financing from government-sponsored financing entities account for their obligations under other relevant accounting pronouncements, and concluded that it was not necessary for the VIE consolidation requirements of ASC Subtopic 810-10 to apply to those entities. However, as with other scope exceptions, anti-abuse provisions exist to prevent an enterprise from using a financing entity established by a governmental organization to circumvent the VIE provisions of ASC Subtopic 810-10.
Question 2.2.40.1: Governmental Organizations with Interests in VIEs

Could a VIE be consolidated by a governmental entity under the provisions of ASC Subtopic 810-10?

Interpretive Response: If a governmental entity follows the accounting standards issued by the GASB and has not elected to apply the standards issued by the FASB under the provisions of GASB Statement No. 20, Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting, then that governmental entity is not required to apply the provisions of ASC Subtopic 810-10.

Question 2.2.40.2: VIEs That Are Governmental Entities

If a reporting enterprise has a variable interest in a governmental entity (e.g., an operating lease containing a residual value guarantee), could the governmental entity be a VIE that is subject to potential consolidation by the enterprise?

Interpretive Response: Generally no. Governmental entities (domestic or foreign) are excluded from the scope of the VIE provisions of ASC Subtopic 810-10. However, entities that are not governmental entities but that are formed by a governmental entity are not excluded from the scope of the VIE provisions of ASC Subtopic 810-10 and, therefore, the VIE consolidation and disclosure requirements of ASC Subtopic 810-10 may apply to those entities. In addition, governmental financing entities (e.g., tax-exempt bond financing trusts) are not excluded from the scope of the VIE provisions of ASC Subtopic 810-10 if they are designed to circumvent those provisions.

A governmental entity is defined (in AICPA Audit and Accounting Guide, State and Local Governments, June 2016 edition) as having one or more of the following characteristics: popular election of officers or appointment (or approval) of a controlling majority of the members of the organization’s governing body by officials of one or more state or local governments; the potential for unilateral dissolution by a government with the net assets reverting to a government; or the power to enact and enforce a tax levy.

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

In certain instances, a financing entity (such as a financing trust) may be formed by a domestic or foreign governmental organization for the specific purpose of allowing a nongovernmental enterprise to obtain lower cost
financing as an incentive for the enterprise to invest in a particular governmental jurisdiction. If the entity is itself a governmental entity, it would be subject to the VIE provisions of ASC Subtopic 810-10 if it were used by the enterprise to avoid applying the VIE provisions of ASC Subtopic 810-10. However, it is unlikely that an entity that issues debt that meets all of the requisite criteria to be tax exempt could be used to avoid the VIE provisions of ASC Subtopic 810-10 without triggering the loss of its ability to issue debt with preferential tax treatment. Accordingly, an entity that issues interest-bearing debt that qualifies to be exempt from federal taxation generally would be expected to fall outside the scope of the VIE provisions of ASC Subtopic 810-10.

2.2.50. Registered Money Market Funds

2.2.50.10. Similar to the deferral of the VIE consolidation requirements in ASU 2009-17 (see paragraph 1.1.40.10 for additional discussion), the FASB decided in ASU 2015-02 to exclude from the scope of ASC Topic 810 money market funds that:

- Are required to comply with Rule 2a-7 of the Investment Company Act of 1940; or
- Operate in accordance with requirements that are similar to those in Rule 2a-7 of the Investment Company Act of 1940.

The FASB provided guidance to clarify the meaning of similar. The Board does not expect significant differences from how money market funds are currently evaluated for purposes of the deferral of ASU 2009-17.

2.2.50.20. Fund sponsors of money market funds excluded from the scope of ASC Topic 810 are no longer subject to the disclosure requirements that apply to VIEs. However, they will be required to disclose arrangements to provide support to the money market funds they manage and any instances of support provided for the periods presented in the performance statement.

Question 2.2.50.1: Requirements That Are Similar to Those That Apply to Registered Money Market Funds

How should a reporting enterprise evaluate whether an entity complies or operates in accordance with requirements that are similar to those in Rule 2a-7 of the Investment Company Act of 1940 (1940 Act) for registered money market funds?

**Background:** Entities that are required to comply or operate in accordance with requirements similar to those in Rule 2a-7 of the 1940 Act are exempt from the consolidation requirements in ASC Topic 810.

Sponsors of registered money market funds may provide financial support to the fund for various reasons, including to keep the fund from breaking the buck. This support may be provided in various ways, including but not limited
to purchases of investments from the fund for prices greater than fair value, fee waivers, etc. Support provided voluntarily to a money market fund by its sponsor generally causes the sponsor to have an implicit variable interest that absorbs significant risks of the fund. As a result of the sponsor’s implicit variable interest, under the new consolidation guidance in ASU 2015-02 without considering the exemption:

- The fund generally would meet the criteria to be a VIE, and
- The sponsor generally would meet the criteria to be the fund’s primary beneficiary.

However, requiring consolidation of a money market fund by its sponsor would not be responsive to feedback from the FASB’s constituents that the sponsor’s financial statements are more useful if the sponsor does not consolidate the fund. Rather than tailor the new consolidation model to provide a non-consolidation outcome in these unique situations, the FASB decided to add a new scope exception to the consolidation requirements in ASC Topic 810 for registered money market funds and similar entities.

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

- Invest at least 97% of its total assets in Tier 1 securities with remaining maturities of 397 days or less and up to 3% of its total assets in Tier 2 securities with remaining maturities of 45 days or less;  
- Maintain an average dollar-weighted maturity of 60 days or less; and  
- Invest no more than five percent of total assets in the same issuer and no more than one half of one percent of total assets in Tier 2 securities of any single issuer.

Registered investment funds, including registered MMFs, are also required to establish a board of directors that elects the investment advisor and is controlled by the Fund’s shareholders.

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1 In September 2015, the SEC adopted amendments to Rule 2a-7 (Rule 2a-7 as amended, or amended rules), and made conforming changes to the form that money market funds use to report information to the SEC about their portfolio holdings. The amendments are effective October 26, 2015 with a compliance date of October 14, 2016.
2 Under Rule 2a-7 as amended, a money market fund may invest in a security only if the fund determines that the security presents minimal credit risks after analyzing certain prescribed factors. Money market funds no longer will be limited to investing only in securities that have received one of the two highest short-term credit ratings, or if they are not rated, securities that are of comparable quality to those highest-rated securities. Additionally, money market funds no longer will be required to invest at least 97% of their assets in securities that have received the highest short-term credit ratings.
3 Under Rule 2a-7 as amended, there will no longer be a requirement to invest no more than one half of one percent of total assets in Tier 2 securities of any single issuer.
The evaluation of whether an entity complies or operates in accordance with requirements that are similar to those in Rule 2a-7 of the 1940 Act for registered MMFs should be based on the entity’s purpose and design, including the risks the entity was designed to create and pass through to its investors. An entity’s purpose and design is evidenced by the contractual requirements that govern its operations/investments as well as its actual operations since it was established. An entity that is similar to a registered MMF should allow for investor redemptions from the fund on a daily basis at the entity’s net asset value (NAV) per share.

Because a non-registered MMF is unlikely to voluntarily comply with all of the requirements of Rule 2a-7, the following information is intended to assist in assessing whether an investment company can be considered similar to a registered MMF. We believe that except for providing for investor redemptions on a daily basis, the provisions in Rule 2a-7 generally are not individually mandatory such that noncompliance with an individual provision would not automatically disqualify an entity from being considered similar to a registered MMF. Professional judgment is required in performing the assessment.

At a high level the purpose and design of an entity that is similar to a registered MMF should be to:

- Invest in high-quality, short-term securities that are judged to present minimal credit risk;
- Seek to maintain a constant NAV per share (e.g., $1) by minimizing the fund’s exposure to interest rate and credit risk;
- Follow an overall objective related to the credit quality and maximum maturity of eligible investments, the diversification of the fund’s portfolio as well as its overall average maturity that is designed to ensure that the entity’s fair value remains at the constant NAV; and
- Allow for investor redemptions on a daily basis.

Paragraph BC82 of ASU 2015-02 indicates that the FASB believes an entity that is similar to a registered MMF would “seek to maintain the principal investment by minimizing the fund’s exposure to credit risk and allowing for investor redemptions from the fund on a daily basis.” Paragraph BC82 states further that “the Board expects entities to assess whether the fund’s portfolio quality, maturity, and diversification are similar to a money market fund that complies with or operates in accordance with Rule 2a-7, with a focus on the following:

(a) Portfolio quality: Invest in high-quality, short-term securities that are judged to present credit risk similar to investments held by a money market fund that complies with or operates in accordance with Rule 2a-7.

(b) Portfolio maturity and diversification: Follow an overall objective regarding the credit quality and maximum maturity of eligible
investments, the diversification of the fund’s portfolio, and its overall average maturity that is consistent with a money market fund that complies with or operates in accordance with Rule 2a-7.”

Assessment Criteria
To comply with these design principles it is expected that the specific requirements of a non-registered MMF will not diverge significantly from the objectives of Rule 2a-7. The section below summarizes the current Rule 2a-7 requirements.

Stable NAV Per Share Calculation
The entity seeks to maintain a constant NAV per share (e.g., $1) and performs a shadow calculation to monitor the difference between fair value and book value/amortized cost.

<table>
<thead>
<tr>
<th>2a-7 Reference</th>
<th>2a-7 Requirement</th>
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</thead>
<tbody>
<tr>
<td>2a-7c1</td>
<td>Maintain a stable NAV per share or stable price per share</td>
</tr>
<tr>
<td>2a-7c</td>
<td>Can compute NAV using amortized cost method (as opposed to fair value) or penny rounding method, subject to shadow pricing by the Board of Directors</td>
</tr>
</tbody>
</table>

Credit Quality
The entity has restrictions on the credit quality of its investments that are designed to limit the credit risk to the investors.

Before the amended rules, a significant portion of the entity’s investments are held in the highest quality securities (defined as Tier 1 under Rule 2a-7, but could reference other rating agency classifications). In addition, the entity has a prohibition or very low limit on the amount of its investments that can be held in lower credit rated investments (e.g., below Tier 2 securities as defined in Rule 2a-7).

<table>
<thead>
<tr>
<th>2a-7 Reference</th>
<th>2a-7 Requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>2a-7c3</td>
<td>At least 97% of total assets must be invested in Tier 1 securities or its equivalent (i.e., highest rating available for a short-term debt</td>
</tr>
</tbody>
</table>

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4 In July 2014 the SEC adopted amendments to regulations that govern registered money market funds. Effective October 14, 2016 certain institutional registered money market funds would be required to base their NAV on the current market price of the securities rather than amortized cost.
| 2a-7c3 | Up to 3% of total assets may be invested in Tier 2 securities (i.e., second highest rating of a debt security) with remaining maturities of 45 days or less |

With the amended rules, money market funds no longer will be limited to investing in only securities that have received one of the two highest short-term credit ratings. Instead, money market funds may invest in a security only if the fund determines that the security presents minimal credit risks after analyzing the following factors.

- **Financial condition**, which generally should include an examination of recent financial statements and consideration of trends relating to cash flow, revenue, expenses, profitability, short-term and total debt service coverage, and leverage (including financial and operating leverage).

- **Sources of liquidity**, which generally should include a consideration of bank lines of credit and alternative sources of liquidity.

- **Ability to react to future market-wide and issuer- or guarantor-specific events**, including the ability to repay debt in a highly adverse situation. This factor generally should include an analysis of risk from various scenarios, including changes to the yield curve or spreads, especially in a changing interest rate environment; and

- **Strength of the issuer’s or guarantor’s industry within the economy and relative to economic trends, and issuer’s or guarantor’s competitive position within its industry**. This factor generally should include consideration of diversification of sources of revenue, if applicable.

The SEC noted that codifying these factors should help to achieve its goal of maintaining a similar degree of credit risk as in money market fund portfolios before the amended rules.

**Maturity**

The entity has restrictions on the weighted average portfolio maturity (or duration) that are not significantly different from the Rule 2a-7 requirement of 60 days or less.
<table>
<thead>
<tr>
<th>2a-7 Reference</th>
<th>2a-7 Requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>2a-7c2(i)</td>
<td>Acquire an instrument only with a remaining maturity of 397 calendar days or less</td>
</tr>
<tr>
<td>2a-7c2(ii)</td>
<td>Maintain a dollar-weighted average portfolio maturity of 60 days or less</td>
</tr>
</tbody>
</table>

Diversification

The entity has restrictions on the quantity of investments from individual issuers that results in significant diversification.

<table>
<thead>
<tr>
<th>2a-7 Reference</th>
<th>2a-7 Requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>2a-7c4</td>
<td>No more than 5% of total assets invested in one issuer</td>
</tr>
<tr>
<td>2a-7c4(i)C</td>
<td>No more than one half of one percent of total assets in Tier 2 securities issued by a single issuer. (No longer applicable under Rule 2a-7 as amended).</td>
</tr>
<tr>
<td>2a-7c4(iii)</td>
<td>Other limits on the percentage of total assets in securities issued or guaranteed by, or having demand features to, one entity</td>
</tr>
</tbody>
</table>

Management Oversight—Overall Control

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

Other Conditions

- A Single Class of Shareholders: Registered MMFs generally do not have more than one class of shareholders for purposes of allocating investment risks (there may be multiple shareholder classes for purposes of determining the expenses charged to investors). Multiple shareholder classes that disproportionately allocate investment risks between the classes is a strong
indication that the entity is not designed to be similar to a registered MMF.

- **Debt or Leverage:** Registered MMFs are restricted from borrowing funds and creating leveraged returns, therefore, the ability to borrow is a strong indication that the entity is not designed to be similar to a registered MMF.

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**Question 2.2.50.2: Disclosure Requirements for Registered Money Market Funds and Entities That Are Similar to Registered Money Market Funds**

Are reporting enterprises with interests in registered MMFs and entities that are similar to registered MMFs subject to the disclosure requirements that apply to VIEs?

**Interpretive Response:** No. Reporting enterprises with an interest in registered MMFs and entities that are similar to registered MMFs are exempt from the disclosure requirements that apply to VIEs. However, a reporting enterprise is required to disclose financial support that it has provided or agreed to provide to registered MMFs or entities that are similar to registered MMFs. ASC subparagraph 810-10-15-12(f)(2) provides a list of the types of financial support that should be considered. The list is not all-inclusive.

The disclosure requirements when a reporting enterprise has provided or agreed to provide financial support to registered MMFs or entities that are similar to registered MMFs apply regardless of the reason that the reporting enterprise provided the support. For example, if a reporting enterprise is the sponsor of a MMF and waives some or all of its management fee to improve the MMF’s return for competitive reasons, the fee waiver would be subject to the disclosure requirement in ASC subparagraph 810-10-15-12(f)(2) even if the fee waiver was not necessary to keep the MMF from breaking the buck.

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**2.3 VIE SCOPE EXCEPTIONS**

**Excerpt from ASC Subtopic 810-10**

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

(a) **Not-for-profit entities** (NFPs) are not subject to the Variable Interest Entities Subsections, except that they may be related parties for purposes of applying paragraphs 810-10-25-42 through 25-44. In addition, if an NFP is used by business reporting entities in a manner similar to a VIE in an effort to circumvent the provisions of the Variable Interest Entities Subsections, that NFP shall be subject to the guidance in the Variable Interest Entities Subsections.
(b) Separate accounts of life insurance entities as described in Topic 944 are not subject to consolidation according to the requirements of the Variable Interest Entities Subsections.

(c) A reporting entity with an interest in a VIE or potential VIE created before December 31, 2003, is not required to apply the guidance in the Variable Interest Entities Subsections to that VIE or legal entity if the reporting entity, after making an exhaustive effort, is unable to obtain the information necessary to do any one of the following:

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

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

(d) A legal entity that is deemed to be a business need not be evaluated by a reporting entity to determine if the legal entity is a VIE under the requirements of the Variable Interest Entities Subsections unless any of the following conditions exist (however, for legal entities that are excluded by this provision, other generally accepted accounting principles [GAAP] should be applied):

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

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

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

2.3.10. Overview

2.3.10.10. When the enterprise or entity does not qualify for a consolidation guidance scope exception as described in Subsection 2.2, the enterprise should evaluate whether the enterprise or entity qualifies for a scope exception to the VIE provisions of ASC Subtopic 810-10. If the enterprise or the entity qualifies for one or more of those scope exceptions, then the enterprise is not required to apply the VIE consolidation or disclosure requirements of ASC Subtopic 810-10 and instead applies the general consolidation provisions of ASC Subtopic 810-10. If neither the enterprise nor the entity qualifies for one or more of the scope exceptions to the VIE provisions of ASC Subtopic 810-10, then the enterprise must evaluate whether it has a variable interest in the entity, and if so, whether the entity is a VIE for purposes of the consolidation and disclosure requirements of ASC Subtopic 810-10. See also Subsection 2.4 for common control leasing arrangements for a private company.

2.3.10.20. An enterprise should carefully evaluate the VIE scope exceptions because the entities to which the VIE scope exceptions apply are not exempt from the VIE provisions of ASC Subtopic 810-10 under all circumstances. Entities not subject to the literature referenced in the VIE scope exceptions are subject to the VIE provisions of ASC Subtopic 810-10 unless the Board or FASB staff indicates otherwise. For example, a separate account of an insurance company that is not a life insurance entity as described in the AICPA Audit and Accounting Guide, Life and Health Insurance Entities, is subject to the VIE provisions of ASC Subtopic 810-10. The FASB also has observed that the guidance in ASC subparagraph 810-10-15-17(d) does not represent a blanket scope exception for franchise or joint venture arrangements. Analogies to any of the VIE scope exceptions generally are inappropriate unless the Board or FASB staff indicates otherwise.
2.3.10.30. The following flowchart summarizes the VIE scope exceptions.

![Flowchart](image)

2.3.20. Not-for-Profit Organizations

2.3.20.10. The VIE provisions of ASC Subtopic 810-10 are a clarification of FASB Accounting Research Bulletin No. 51, *Consolidated Financial Statements* (the non-VIE provisions of ASC 810-10), which applied to business enterprises only. Thus, the FASB did not consider it appropriate to extend the VIE provisions of ASC Subtopic 810-10 to not-for-profit organizations. However, the FASB
recognized that the not-for-profit scope exception might give rise to attempts to structure transactions to circumvent the VIE provisions of ASC Subtopic 810-10. As a result, the scope exception includes an abuse prevention provision: if a not-for-profit organization is being used like a VIE by a business enterprise to circumvent the ASC Subtopic 810-10 VIE provisions, that not-for-profit organization is included in the scope of the ASC Subtopic 810-10 VIE provisions.

2.3.20.20. Determining whether a not-for-profit organization is being used by a business enterprise to circumvent the ASC Subtopic 810-10 VIE provisions depends on the specific facts and circumstances, and requires an assessment of management’s intent. Consider the following example:

Example 2.3.20.1: Charitable Foundation as Lessor

Company A wants to lease an aircraft from a lessor trust created specifically to facilitate the financing of the particular transaction. However, Company A concludes that even though the lease is an operating lease under ASC Topic 840, Leases, the lessor trust would be a VIE that Company A would be required to consolidate based on the terms of the lease. As a result, Company A modifies the transaction structure so that the principal lender’s charitable foundation becomes the aircraft lessor and Company A leases the aircraft from the charitable foundation. Because Company A is using the lender’s charitable foundation to avoid consolidation under the VIE provisions of ASC Subtopic 810-10, Company A should apply those provisions of ASC Subtopic 810-10 to its involvement with the charitable foundation.

Example 2.3.20.2: Political Action Committees

Background

XYZ Corp. recently established a Political Action Committee (PAC) to accept voluntary contributions from higher-level employees, directors and shareholders for disbursement to political candidates who have taken responsible positions on issues affecting XYZ. In accordance with its bylaws, XYZ cannot make contributions to the PAC. The PAC operates as a tax exempt political organization within the meaning of Section 527(e)(1) of the IRC. It is not organized for profit and no part of net earnings shall benefit XYZ or its employees. In the event of dissolution, assets of the PAC will be transferred to another qualifying nonprofit organization. The PAC has no members or capital stock. The affairs of the PAC are managed by its Board of Directors, which is appointed by XYZ's CEO. The Board members have the authority to make changes to the bylaws and dissolve the PAC.

Evaluation

XYZ first evaluates whether or not the PAC meets the scope exception for not-for-profit organizations.
The PAC meets the definition of a not-for-profit organization because (a) the PAC will receive assets/resources from resource providers who will not receive a direct return or benefit, (b) the operating purpose of the PAC is not to provide goods or services at a profit but rather to support political activities, and (c) the PAC does not have ownership interests like those of a business. In addition, the PAC will not inure to the benefit of any member of the PAC Board of Directors and XYZ will not receive a commensurate or pecuniary return (or economic benefit) in any case, including in the event of the PAC’s dissolution. Additionally, Political Action Committees are included in the list of not-for-profit entities in ASC paragraph 958-10-15-3.

While the PAC meets the definition of a not-for-profit entity, for the scope exception to apply, XYZ also needs to conclude that the PAC is not being used like a VIE to circumvent the ASC Subtopic 810-10 VIE provisions. In this case, we believe XYZ can support application of the scope exception because it is not being used in a similar manner to a VIE and XYZ will not absorb expected losses or receive expected residual returns of the PAC. Shareholders and employees that contribute to the PAC share collectively with XYZ in potential benefits associated with the PAC (i.e., XYZ alone does not directly realize any of the potential benefits). Additionally, the benefits received are indirect and intangible given that a favorable political or other action is not the direct result of a distribution.

Because the PAC is not subject to the guidance in the VIE subsections of ASC Subtopic 810-10, XYZ evaluates the PAC for consolidation under the guidance for voting interest entities in Subtopic 810-10. Given the inherent limits imposed on the PAC as a result of being a qualifying not-for-profit organization established under relevant tax law, XYZ likely would conclude that it does not consolidate the PAC because it does not substantively control the PAC, notwithstanding the CEO’s authority to appoint the PAC’s Board of Directors. The FASB addressed a similar fact pattern relative to charitable foundations in its 1999 FASB Exposure Draft on Consolidated Financial Statements: Purpose and Policy. In the Exposure Draft, the FASB reasoned that a charitable foundation established to qualify as a charitable organization under the Internal Revenue Code should not be consolidated by the sponsoring organization (even when the sponsoring organization controls the foundation's board) because the sponsoring organization/directors lacked control over the foundation. While the FASB’s Exposure Draft has not been finalized and issued as an amendment to the Codification, it gives some relevant insight into the underlying principles behind consolidating not-for-profit organizations and may be used as a data point to support the conclusion not to consolidate the PAC.

We understand that some may have taken an alternative view that because the Board of the PAC consists solely of members of XYZ’s management, determines the recipients of the political contributions, and the PAC solely benefits XYZ, the PAC is being used by XYZ in a manner similar to a VIE to circumvent the provisions of the VIE subsections of Subtopic 810-10. However, under this view, XYZ would not consolidate the PAC because XYZ likely does
not have a variable interest in the PAC. Even if XYZ was identified as the single-decision maker via its CEO’s ability to appoint the Board, XYZ would not have a variable interest in the PAC if all the conditions in ASC paragraph 810-10-55-37 are met. However, if XYZ were considered the PAC’s single decision maker and one or more of the conditions in ASC paragraph 810-10-55-37 were not met, then XYZ likely would be the PAC’s primary beneficiary because the conditions in ASC paragraph 810-10-25-38A likely would be met. See additional discussion about identifying variable interests in Section 3, Variable Interests, and about identifying the primary beneficiary in Section 6, Primary Beneficiary Determination and Reconsideration.

2.3.20.30. Finally, it is important to emphasize that a not-for-profit organization may be a related party of an enterprise for purposes of evaluating whether the enterprise should consolidate a VIE. The determination of who in a related party group, if any, should consolidate a VIE is addressed in Section 7, Related Parties and De Facto Agency Relationships. A not-for-profit organization could be a related party of an enterprise if, for example, the enterprise contributed the variable interest(s) held by the not-for-profit organization in an entity.

Question 2.3.20.1: Not-for-Profit Organizations with Interests in VIEs

What guidance should a not-for-profit organization with an interest in a VIE apply to determine whether it must consolidate the VIE? For example, if a not-for-profit organization enters into a lease with a lessor that meets the conditions in ASC Subtopic 810-10 to be considered a VIE, what guidance should the not-for-profit organization apply to determine whether to consolidate the lessor?

Interpretive Response: ASC subparagraph 810-10-15-17(a) indicates that not-for-profit organizations generally are not subject to the VIE guidance in ASC Subtopic 810-10. ASC paragraphs 958-810-25-8 through 25-10 and 958-810-55-7 through 55-16 (previously EITF Issue No. 90-15, Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions, and EITF Issue No. 96-21, Implementation Issues in Accounting for Leasing Transactions involving Special-Purpose Entities) provide guidance that is explicitly required to be applied by not-for-profit organizations in evaluating whether to consolidate special-purpose lessor entities. We believe that not-for-profit organizations should apply the provisions of ASC paragraphs 958-810-25-8 through 25-10 and 958-810-55-7 through 55-16 by analogy in assessing whether to consolidate all special-purpose entities with which they have involvement. We understand that the FASB expects the term special-purpose entity to include any entity whose activities are primarily related to securitizations or other forms of asset-backed financings or single-lessee leasing arrangements. Not all VIEs are special-purpose entities and not all special-purpose entities are VIEs. Not-for-profit organizations evaluating whether to consolidate VIEs that are not special-purpose entities should apply the guidance in ASC Subtopic 958-810, Not-for-Profit Entities - Consolidation.
Question 2.3.20.2: For-Profit Subsidiaries of Not-for-Profits

Can a for-profit subsidiary of a not-for-profit apply the not-for-profit scope exception?

Interpretive Response: No, consolidation of the for-profit subsidiary by the not-for-profit parent entity does not result in any change to the accounting treatment applied to relationships with variable interest entities by the for-profit subsidiary.

While not-for-profit entities are scoped out of the VIE subsections of Subtopic 810-10, wholly owned subsidiaries that do not meet the definition of a not-for-profit entity in the Master Glossary are not allowed to use the not-for-profit scope exception in ASC subparagraph 810-10-15-17(a). These subsidiaries are required to evaluate relationships with variable interest entities to determine whether they have a controlling financial interest in the entity through means other than voting rights and accordingly should consolidate the entity.

2.3.20.40. In January 2017, the FASB issued Accounting Standards Update No. 2017-02, Clarifying When a Not-for-Profit Entity That is a General Partner or a Limited Partner Should Consolidate a For-Profit Limited Partnership or Similar Entity (ASU 2017-02). The FASB issued ASU 2017-02 to clarify how not-for-profit entities should evaluate for consolidation partnership investments after the adoption of ASU 2015-02.

2.3.20.50. Under ASU 2015-02, investors in limited partnerships must first evaluate whether those partnerships are variable interest entities. If so, the variable interest entity consolidation guidance applies. If not, the voting interest entity consolidation guidance applies. ASU 2015-02 also changed how investors in partnerships that are voting interest entities evaluate those partnerships for consolidation. It eliminated the presumption that the general partner controls a limited partnership. Instead, it requires investors to evaluate partnerships that are voting interest entities in generally the same manner as corporations that are voting interest entities (i.e., based on whether the investor has a majority of the voting rights). Because ASU 2015-02 first requires investors to evaluate whether the partnership is a variable interest entity and NFPs generally do not apply the VIE guidance (as discussed above), it was unclear how NFPs should evaluate whether to consolidate for-profit limited partnerships.

2.3.20.60. ASU 2017-02 restores the pre-ASU 2015-02 consolidation guidance related to partnerships and similar entities that are not variable interest entities. NFPs that are general partners are, once again, presumed to control a limited partnership, regardless of the extent of their ownership interest, unless the limited partners have substantive participating or kick-out rights. The ASU also states that the FASB did not intend to change the fair value elections currently available to NFPs. It clarifies that the consolidation guidance does not apply to a
NFP that invests in a for-profit limited partnership or similar legal entity if the partnership interest is reported at fair value under U.S. GAAP.

2.3.20.70. ASU 2017-02 is effective for annual periods in fiscal years beginning after December 15, 2016, and interim periods in fiscal years beginning after December 15, 2017, with early adoption permitted. NFPs will apply the new ASU using the same transition method elected for ASU 2015-02. NFPs that have already adopted ASU 2015-02 will apply the new ASU retrospectively to all relevant prior periods beginning with the fiscal year in which ASU 2015-02 initially was adopted.

2.3.30. Separate Accounts of Life Insurance Entities

2.3.30.10. The FASB excluded separate accounts of life insurance entities from the scope of the ASC Subtopic 810-10 VIE provisions because existing accounting standards address those accounts. Specifically, ASC paragraph 944-80-45-1 indicates that separate account assets (i.e., the net assets of the separate account) and liabilities (i.e., the insurance enterprise’s obligation to the separate account holders) ordinarily should be reported as summary totals in the financial statements of the insurance enterprise, and the Board did not want to reconsider those requirements. However, separate accounts may be required to consolidate investees that are VIEs. That is, even though the investors in those separate accounts are exempt from consolidating the accounts, the insurance companies that maintain the accounts should assess whether the investees of their separate accounts are VIEs that require consolidation or disclosure under the provisions of ASC Subtopic 810-10.

2.3.30.20. The scope exception applies only to separate accounts of life insurance entities, described as follows in AICPA Audit and Accounting Guide, Life and Health Insurance Entities:

Excerpt from the AICPA Audit and Accounting Guide, Life and Health Insurance Entities

Paragraph 13.17: Separate accounts represent assets and liabilities that are maintained by an insurance entity and are established primarily for the purpose of funding variable annuity contracts, variable life insurance contracts, modified guaranteed annuity contracts, modified guaranteed life insurance contracts, or other various group contracts under pension or other employee benefit plans where funds are held in a separate account to support a liability. SSAP No. 56, Separate Accounts, paragraph 2 states, “When separate accounts are established and filed accordingly, they may be used to fund guaranteed benefits. Separate account contracts may also be used to accumulate funds which are intended to be applied at some later time to provide life insurance or to accumulate proceeds applied under settlement or dividend options.”

5 ASC Topic 944, Financial Services--Insurance (previously AICPA Statement of Position 03-1, Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts), defines, and provides additional guidance about, the accounting for separate accounts.
2.3.40. Inability to Obtain Information

2.3.40.10. If a reporting enterprise cannot obtain the information necessary to determine whether an entity it is involved with is a VIE, or whether the reporting enterprise is required to consolidate the entity if it is a VIE, in some cases the reporting enterprise is not required to apply the VIE provisions of ASC Subtopic 810-10 to that entity. In addition, even when a reporting enterprise has determined that an entity with which it is involved is a VIE that it must consolidate, the reporting enterprise may not be required to do so if it is unable to obtain the information necessary to perform the consolidation accounting for the VIE. This scope exception sometimes is referred to as the information out scope exception. The scope exception applies only to entities created before December 31, 2003 for which the reporting enterprise has made exhaustive, but unsuccessful efforts to obtain the necessary information. These exhaustive efforts must continue as long as the information out scope exception is applied. ASC paragraph 810-10-50-6 includes disclosure requirements for entities that fall under this provision, and ASC paragraph 810-10-30-7 includes transition guidance for applying the requirements when the information subsequently becomes available.

2.3.40.20. The FASB has indicated that it expects this scope exception to be used infrequently, especially if the reporting enterprise was involved in the formation or restructuring of the entity. An enterprise holding a variable interest in another entity that exposes it to substantial risks would normally obtain information about that entity to monitor its exposure (even if the exposure is limited).

Question 2.3.40.1: Exhaustive Efforts

What constitutes exhaustive efforts for purposes of the information out scope exception in ASC subparagraph 810-10-15-17(c)?

Interpretive Response: There is no guidance in ASC Subtopic 810-10 about what constitutes exhaustive efforts. Certainly serious efforts must continue to be made; however, we understand that the FASB does not, for example, expect the reporting enterprise to resort to legal action to obtain information that it has no contractual right to receive, unless that right has been withheld deliberately to avoid the VIE provisions of ASC Subtopic 810-10. Determining when exhaustive efforts have occurred without successfully obtaining the required information will necessarily depend on the applicable facts and circumstances. Companies that apply this scope exception should document their efforts to obtain the necessary information. In a speech at the 2003 AICPA National Conference on Current SEC Developments, a member of the SEC staff commented on the staff’s expectations about the information out scope exception. An excerpt from the speech follows:
Consolidation of Variable Interest Entities, Section 2

Excerpt from Speech by Eric Schuppenhauer

Our understanding was that this scope exception was provided in response to concerns raised by constituents that they were unable to obtain the information to apply FIN 46 to entities in existence prior to the effective date of FIN 46 because of legal or other barriers, such as privacy laws in foreign jurisdictions. It was intended for those situations and should be limited to those situations.

In this regard, I would like to make a few observations.

First, the scope exception only applies to an enterprise with an interest in a variable interest entity or potential variable interest entity created before December 31, 2003. For instance, in making a determination whether to apply the scope exception, registrants should carefully consider whether the entity was really created prior to December 31st or was merely in existence prior to that date and re-configured in such a way that the creation date of the legal entity is not relevant. For instance, if an entity was inactive for a number of years and then re-activated after December 31st to carry out new activities and issue new variable interests, the staff would consider the use of the information scope exception abusive.

Second, the staff has begun to contemplate the meaning of an exhaustive effort in applying this limited scope exception. Consistent with the thoughts of the FASB, as expressed in the modifications to FIN 46, the staff anticipates that the use of the exception will be infrequent. We plan to deal with instances where the information scope exception is being applied on a case-by-case basis, considering all of the relevant facts and circumstances. In assessing those facts and circumstances, the staff can be expected to consider whether registrants operating in the same industry with similar types of arrangements were able to obtain the requisite information.

In a speech at the 2004 AICPA National Conference on Current SEC and PCAOB Developments, a member of the SEC staff commented further on the staff’s expectations about the information out scope exception. An excerpt from the speech follows:

Excerpt from Speech by Jane D. Poulin

I would also like to address the information scope out in FIN 46R. While the staff recognizes that FIN 46R is a challenging area, it is a company’s responsibility to prepare financial statements in accordance with GAAP. The staff believes that an investor has the same responsibility for analyzing whether to consolidate a variable interest entity, and for preparing financial statements in which a variable interest entity is consolidated, as they do in the case of a voting interest entity. FIN 46R only includes an information out for enterprises involved in entities created prior to December 31, 2003. We, therefore, expect that all the information necessary to make a FIN 46R
assessment and, if required, to consolidate a variable interest entity is available for entities created after December 31, 2003. Additionally, in those cases where a company believes they can avail themselves of the information out for entities created before December 31, 2003, companies should be prepared to support how you have satisfied the exhaustive efforts criterion.

4 FIN 46R, paragraph 4(g) [ASC paragraph 810-10-15-17(c)].

2.3.50. Entities That Are Businesses

2.3.50.10. A reporting enterprise is not required to evaluate an entity under the VIE provisions of ASC Subtopic 810-10 if the entity is deemed to be a business and none of the conditions in ASC subparagraph 810-10-15-17(d) are met. The criteria used by ASC Subtopic 810-10 to evaluate whether an entity is a business are based on the guidance in ASC Section 805-10-55. For entities that are businesses, the conditions that would require evaluation under the VIE provisions of ASC Subtopic 810-10 are designed to capture situations in which it is most likely that voting interests will be ineffective in identifying controlling financial interests.

2.3.50.20. ASC Subtopic 810-10 defines a business as "[a]n integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants." ASC Subtopic 805-10, Business Combinations - Overall, provides the following additional guidance about what constitutes a business:

Excerpt from ASC Subtopic 805-10

55-4 A business consists of inputs and processes applied to those inputs that have the ability to create outputs. Although businesses usually have outputs, outputs are not required for an integrated set to qualify as a business. The three elements of a business are defined as follows:

(a) Input. Any economic resource that creates, or has the ability to create, outputs when one or more processes are applied to it. Examples include long-lived assets (including intangible assets or rights to use long-lived assets), intellectual property, the ability to obtain access to necessary materials or rights, and employees.

(b) Process. Any system, standard, protocol, convention, or rule that when applied to an input or inputs, creates or has the ability to create outputs. Examples include strategic management processes, operational processes, and resource management processes. These processes typically are documented, but an organized workforce having the necessary skills and experience following rules and conventions may provide the necessary processes that are capable
of being applied to inputs to create outputs. Accounting, billing, payroll, and other administrative systems typically are not processes used to create outputs.

(c) Output. The result of inputs and processes applied to those inputs that provide or have the ability to provide a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants.

55-5 To be capable of being conducted and managed for the purposes defined, an integrated set of activities and assets requires two essential elements -- inputs and processes applied to those inputs, which together are or will be used to create outputs. However, a business need not include all of the inputs or processes that the seller used in operating that business if market participants are capable of acquiring the business and continuing to produce outputs, for example, by integrating the business with their own inputs and processes.

55-6 The nature of the elements of a business varies by industry and by the structure of an entity’s operations (activities), including the entity’s stage of development. Established businesses often have many different types of inputs, processes, and outputs, whereas new businesses often have few inputs and processes and sometimes only a single output (product). Nearly all businesses also have liabilities, but a business need not have liabilities.

55-7 An integrated set of activities and assets in the development stage might not have outputs. If not, the acquirer should consider other factors to determine whether the set is a business. Those factors include, but are not limited to, whether the set:

(a) Has begun planned principal activities
(b) Has employees, intellectual property, and other inputs and processes that could be applied to those inputs
(c) Is pursuing a plan to produce outputs
(d) Will be able to obtain access to customers that will purchase the outputs.

Not all of those factors need to be present for a particular integrated set of activities and assets in the development stage to qualify as a business.

55-8 Determining whether a particular set of assets and activities is a business should be based on whether the integrated set is capable of being conducted and managed as a business by a market participant. Thus, in evaluating whether a particular set is a business, it is not relevant whether a seller operated the set as a business or whether the acquirer intends to operate the set as a business.
In the absence of evidence to the contrary, a particular set of assets and activities in which goodwill is present shall be presumed to be a business. However, a business need not have goodwill.

2.3.50.25. In January 2017, the FASB issued Accounting Standards Update No. 2017-01, Clarifying the Definition of a Business (ASU 2017-01). Under ASU 2017-01, an integrated set of activities and assets (a set) is a business if it has, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs. ASU 2017-01 also creates an initial screening test that reduces the population of transactions that an entity needs to analyze to determine whether there is an input and a substantive process in the set. Under the new model, fewer sets are expected to meet the definition of a business and thus fewer will be eligible for the scope exception as discussed above. ASU 2017-01 is effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2017. It is effective for other entities for annual periods in fiscal years beginning after December 15, 2018 and interim periods in fiscal years beginning after December 15, 2019. Early adoption is permitted.

Question 2.3.50.1: Participation in Design or Redesign of an Entity

How should a variable interest holder determine whether it participated significantly in the design or redesign of an entity for purposes of evaluating the condition in ASC subparagraph 810-10-15-17(d)(1)?

Interpretive Response: A variable interest holder’s determination of whether it participated significantly in the design or redesign of an entity should consider all relevant facts and circumstances. We believe the phrase design or redesign of the entity refers to the nature and selection of (a) the activities in which the entity is engaged, (b) the entity’s legal structure, and/or (c) the entity’s variable interests. A change in the entity’s legal structure or in its variable interests, for example, would represent a redesign event even if there is no change in the activities in which the entity is engaged.

We believe a variable interest holder generally would be deemed to participate significantly in the design or redesign of an entity when the variable interest holder obtains new or recently-issued variable interests in the entity that are significant to the entity, is involved in creating the entity or changing its governing documents or structure (e.g., by having the right to approve the entity’s governing documents or changes to those documents), or is involved in selecting or approving the activities in which the entity is engaged or changes to those activities regardless of whether other parties are also involved in those activities. A variable interest holder generally would be deemed to participate significantly in the design or redesign of an entity in the event of similar involvement with the entity by the variable interest holder’s related parties.
Question 2.3.50.2: Interests in Operating Joint Ventures

What type of entity is considered an operating joint venture for purposes of the condition in ASC subparagraph 810-10-15-17(d)(1)?

Interpretive Response: We believe that the most appropriate definition of a joint venture for purposes of the condition in ASC subparagraph 810-10-15-17(d)(1) is found in the 1979 AICPA Issues Paper, “Joint Venture Accounting”. In paragraph 51(b) of that Issues Paper, the AICPA’s Accounting Standards Executive Committee (AcSEC) concluded that a joint venture is:

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

The AcSEC definition of a joint venture establishes joint control over the decision making of an entity as the key consideration in evaluating whether the entity is a joint venture. Joint control involves joint decision making over all key decisions including significant acquisitions and dispositions and issuance or repurchase of equity interests, among others. We believe that this type of arrangement is distinguishable from other arrangements in which parties involved with an entity share equally in its economic risks and rewards but not in the decisions about its activities. Put or call options between or among parties may affect whether the entity is a joint venture that is subject to joint control similar to the way in which such a call option affects whether participating rights are substantive under the guidance in ASC subparagraph 810-10-25-13(f).

The AcSEC definition of a joint venture contains little guidance about the conditions that must be met for a joint venture to be considered an operating joint venture. We believe that there is some interplay between the characteristics that cause an entity to meet the definition of a business in ASC Section 810-10-20 and ASC paragraphs 805-10-55-4 through 55-9 and the characteristics that would cause a joint venture to be an operating joint venture.

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6 The definition of a corporate joint venture in ASC Section 323-10-20 does not include joint decision making as a distinguishing feature of the arrangement. As a result, we believe that the AcSEC definition is more consistent with the requirements of ASC subparagraph 810-10-15-17(d)(1), which refers to an operating joint venture under joint control of the reporting enterprise and one or more independent parties.
venture. Specifically, if a joint venture is project-specific with a limited life, or outsources a substantial portion of its operations (particularly if those operations are outsourced to its venturers) so that the venture does not have the ability to sustain and perpetuate its existence by obtaining access to new customers and developing or modifying its products or services, we do not believe that the entity would be an operating joint venture.

Question 2.3.50.3: Interests in Franchisees

How is the determination made under ASC subparagraph 810-10-15-17(d)(1) as to whether a reporting enterprise holds a variable interest in an entity that is a franchisee?

Interpretive Response: According to ASC Topic 952, Franchisors, a franchisee is a party that has been granted business rights to operate a franchised business in a franchise agreement with a franchisor (the party that grants the rights to operate the franchised business). ASC Section 952-10-20 contains the following definition of a franchise agreement:

Excerpt from ASC Section 952-10-20

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

(a) The relation between the franchisor and franchisee is contractual, and an agreement, confirming the rights and responsibilities of each party, is in force for a specified period.

(b) The continuing relation has as its purpose the distribution of a product or service, or an entire business concept, within a particular market area.

(c) Both the franchisor and the franchisee contribute resources for establishing and maintaining the franchise. The franchisor’s contribution may be a trademark, a company reputation, products, procedures, manpower, equipment, or a process. The franchisee usually contributes operating capital as well the managerial and operational resources required for opening and continuing the franchised outlet.

(d) The franchise agreement outlines and describes the specific marketing practices to be followed, specifies the contribution of each party to the operation of the business, and sets forth certain operating procedures that both parties agree to comply with.

(e) The establishment of the franchised outlet creates a business entity that will, in most cases, require and support the full-time business activity of the franchisee. (There are numerous other contractual distribution agreements in which a local
businessperson becomes the authorized distributor or representative for the sale of a particular good or service, along with many others, but such a sale usually represents only a portion of the person’s total business).

(f) Both the franchisee and the franchisor have a common public identity. This identity is achieved most often through the use of common trade names or trademarks and is frequently reinforced through advertising programs designed to promote the recognition and acceptance of the common identity within the franchisee’s market area.

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

We believe it would be inappropriate to apply the franchise exception to the condition in ASC subparagraph 810-10-15-17(d)(1) to entities that are not franchisees as described by the foregoing guidance in ASC Topic 952.

**Question 2.3.50.4: Meaning of Substantially All of the Activities of a Business**

How should a variable interest holder determine whether substantially all of the activities of an entity either involve or are conducted on behalf of the variable interest holder and its related parties for purposes of the condition in ASC subparagraph 810-10-15-17(d)(2)?

**Interpretive Response:** Determining whether substantially all of an entity’s activities either involve or are conducted on behalf of the variable interest holder and its related parties (collectively referred to in the remainder of this response as the variable interest holder) requires judgment and consideration of all relevant facts and circumstances. We believe a variable interest holder’s evaluation of this condition in ASC subparagraph 810-10-15-17(d)(2) should be consistent with its evaluation of whether substantially all of an entity’s activities either involve or are conducted on behalf of the variable interest holder when it has disproportionately few voting rights, as required by ASC subparagraph 810-10-15-14(c)(2) for purposes of evaluating whether the entity is a VIE. See Question 4.2.80.2 for considerations that we believe should be included in the analysis.
Question 2.3.50.5: Meaning of Subordinated Financial Support

What is considered subordinated financial support for purposes of the condition in ASC subparagraph 810-10-15-17(d)(3)?

**Interpretive Response:** The answer depends on the facts and circumstances, and is entity-specific. In general, we believe subordinated financial support includes principally the items that an entity’s capital comprises (e.g., equity and debt), generally excluding its most senior debt, as well as guarantees or similar instruments provided to or for the entity, such as off market contracts, commitments to fund losses, and derivatives. ASC subparagraph 810-10-15-17(d)(3) specifically refers to subordinated debt as a form of subordinated financial support but does not mention senior debt as a form of subordinated financial support. ASC Section 810-10-20 provides separate definitions for variable interests and subordinated financial support. ASC Section 810-10-20 states, “Subordinated financial support refers to variable interests that will absorb some or all of an entity’s expected losses.” This suggests that not all variable interests represent subordinated financial support.

**Excerpts from ASC Subtopic 810-10**

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

55-24 …senior beneficial interests and senior debt instruments with fixed interest rates or other fixed returns normally would absorb little of the VIE’s expected variability… By definition, if a senior interest exists, interests subordinated to the senior interests will absorb losses first. The variability of a senior interest with a variable interest rate is usually not caused by changes in the value of the VIE’s assets…

We believe that when an entity issues subordinated interests, other than equity that is at risk under ASC Subtopic 810-10, that are not needed for the entity to finance its activities based solely on the sufficiency of its equity, those subordinated interests generally should not be considered subordinated financial support for purposes of the condition in ASC subparagraph 810-10-15-17(d)(3). We generally also believe that senior debt of an entity with terms and interest rates that indicate that the debt is not of a quality equivalent to investment grade, should be considered subordinated financial support of the entity.
Question 2.3.50.6: Reliance on Another Party’s Evaluation of the Business Scope Exception

Does each of an entity’s variable interest holders need to separately evaluate whether the business scope exception criteria in ASC subparagraph 810-10-15-17(d) have been met?

Interpretive Response: Yes. Each of an entity’s variable interest holders should separately evaluate its eligibility for the business scope exception. It would be inappropriate for a reporting enterprise to base its conclusion about whether it is eligible for the business scope exception on another reporting enterprise’s evaluation of its eligibility for that exception. Each reporting enterprise is responsible for reaching its own judgments and conclusions. In addition, the analysis of ASC subparagraph 810-10-15-17(d) depends in part on enterprise-specific factors (e.g., whether substantially all of the entity’s activities either involve or are conducted on behalf of the reporting enterprise and its related parties).

Question 2.3.50.7: Reassessment of Eligibility for the Business Scope Exception

Once an initial evaluation of a reporting enterprise’s eligibility for the ASC subparagraph 810-10-15-17(d) business scope exception has been completed, is it required to be subsequently reevaluated?

Interpretive Response: Yes. A reporting enterprise would need to continuously evaluate its eligibility for the business scope exception as the factors affecting the conditions in ASC subparagraphs 810-10-15-17(d)(1)-(4) change. If at each evaluation date, none of the conditions in ASC subparagraphs 810-10-15-17(d)(1)-(4) exist, we believe the reporting entity can continue to apply the scope exception and is not required to re-evaluate whether the legal entity is a business (because being a business is not a condition of ASC subparagraph 810-10-15-17(d)).

As discussed in paragraph 2.3.50.25., the FASB recently issued ASU 2017-01. Under the ASU, an integrated set of activities and assets (a set) is a business if it has, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs. Under the new model, fewer sets are expected to meet the definition of a business and thus fewer will be eligible for the scope exception. The ASU is effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2017. It is effective for other entities for annual periods in fiscal years beginning after December 15, 2018 and interim periods in fiscal years beginning after December 15, 2019.

As discussed above, we believe that if at each evaluation date, none of the conditions in ASC subparagraphs 810-10-15-17(d)(1)-(4) exist, the reporting
entity can continue to apply the scope exception and is not required to re-evaluate whether the legal entity is a business. Thus, we do not believe that a reporting enterprise would need to re-evaluate at the adoption of ASU 2017-01 whether it can continue to apply the scope exception to entities that met the definition of a business before the ASU’s effective date but may not meet the new definition, as long as none of the conditions in ASC subparagraphs 810-10-15-17(d)(1)-(4) exist.

2.4. COMMON CONTROL LEASING ARRANGEMENTS FOR A PRIVATE COMPANY

2.4.10. Overview

2.4.10.10. The FASB and Private Company Council (PCC) issued ASU 2014-07, Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements, to give private company lessees the option to not apply the VIE consolidation guidance to some lessor entities. All entities other than public business entities, not-for-profit entities, and certain employee benefit plans, can elect the exemption but must do so for all qualifying leasing arrangements. Employee benefit plans within the scope of ASC Topic 960, Plan Accounting--Defined Benefit Pension Plans, ASC Topic 962, Plan Accounting--Defined Contribution Pension Plans, and ASC Topic 965, Plan Accounting--Health and Welfare Benefit Plans, cannot apply the exemption.

2.4.10.20. Under U.S. GAAP before the effective date of ASU 2014-07, a lessee reporting enterprise generally must evaluate whether the lessor entity is a VIE that the lessee must consolidate. Entities that lease assets from a lessor under common control with the entity are more likely to consolidate those lessors under the VIE guidance because the entity may have an implicit variable interest in the lessor as a result of the guidance on implicit variable interests included in ASC paragraphs 810-10-25-49 through 25-54 and the related example in ASC paragraphs 810-10-55-87 through 55-89 (this implementation guidance is superseded as a result of ASU 2014-07). See Subsection 3.3 for further discussion about implicit variable interests. The PCC and FASB received input from private company stakeholders that the costs of applying the VIE consolidation guidance to common control leasing arrangements outweigh the benefits. Stakeholders indicated that private companies may establish common-control lessor entities for tax, estate-planning, and legal-liability purposes rather than to obtain off-balance sheet financing. Some constituents also indicated that consolidation by a lessee of a lessor entity under common control (1) is not relevant because financial statement users focus on the cash flows and tangible worth of the stand-alone lessee entity without regard to the lessor entity and (2) distorts the financial statements of the lessee because the lessor’s assets are generally not available to satisfy the lessee’s obligations.

2.4.10.25. In June 2017, the FASB issued a proposed ASU, Targeted Improvements to Related Party Guidance for Variable Interest Entities. Under the
proposed amendments, a private company would not need to apply the VIE guidance to legal entities under common control (including common control leasing arrangements) if the parent and the legal entity being evaluated are not public business entities. The accounting alternative would be an accounting policy election that the private company would need to apply to all current and future legal entities under common control. A private company that elects the alternative would be required to provide additional disclosures about these arrangements. Comments on the proposal were due September 5, 2017.

Excerpt from ASC Subtopic 810-10

15-17A A legal entity need not be evaluated by a private company under the guidance in the Variable Interest Entities Subsections if criteria (a) through (c) are met and, in applicable circumstances, criterion (d) is met:

(a) The private company lessee (the reporting entity) and the lessor legal entity are under common control.

(b) The private company lessee has a lease arrangement with the lessor legal entity.

(c) Substantially all activities between the private company lessee and the lessor legal entity are related to leasing activities (including supporting leasing activities) between those two entities.

(d) If the private company lessee explicitly guarantees or provides collateral for any obligation of the lessor legal entity related to the asset leased by the private company, then the principal amount of the obligation at inception of such guarantee or collateral arrangement does not exceed the value of the asset leased by the private company from the lessor legal entity.

15-17B Application of this accounting alternative is an accounting policy election that shall be applied by a private company to all legal entities, provided that all of the criteria for applying this accounting alternative specified in paragraph 810-10-15-17A are met. For lessor legal entities that as a result of this accounting alternative are excluded from applying the guidance in the Variable Interest Entities Subsections, a private company lessee shall continue to apply other accounting guidance (including guidance in the General Subsections of this Subtopic and guidance included in Subtopic 810-20 on control of partnerships and similar entities) as applicable. A private company that elects this accounting alternative shall disclose the required information specified in paragraph 810-10-50-2AD unless the lessor legal entity is consolidated through accounting guidance other than VIE guidance.

15-17C If any of the conditions in paragraph 810-10-15-17A for applying the accounting alternative cease to be met, a private company shall apply the guidance in the Variable Interest Entities Subsections at the date of change on a prospective basis.
55-9 In applying the guidance in paragraph 810-10-15-17A, the following are examples of activities that are considered to be leasing activities (including supporting leasing activities) between a private company lessee and a lessor legal entity:

(a) A guarantee or collateral provided by the private company lessee to the lender of a lessor legal entity under common control for indebtedness that is secured by the asset(s) leased by the private company lessee

(b) A joint and several liability arrangement for indebtedness of the lessor legal entity, for which the private company lessee is one of the obligors, that is secured by the asset(s) leased by the private company lessee

(c) Paying property taxes, negotiating the financing, and maintaining the asset(s) leased by the private company lessee

(d) Paying income taxes of the lessor legal entity when the only asset owned by the lessor legal entity is being leased either by only the private company or by both the private company lessee and an unrelated party.

Paying income taxes of the lessor legal entity on income generated by an asset that is not being leased by the private company lessee is not considered to be a leasing activity between the private company lessee and the lessor legal entity. A purchase commitment (other than for the acquisition of or the support of the leased asset) is not considered to be related to the leasing activity between the private company lessee and the lessor legal entity.

2.4.20. Applying the PCC Alternative

2.4.20.10. A private company lessee can elect not to apply the VIE consolidation guidance if all of the following conditions are met:

- The private company and lessor entity are under common control.
- The private company has a lease arrangement with the lessor.
- Substantially all of the activities between the two entities are related to (or in support of) leasing activities between those two entities.
- The principal amount of any lessor obligation related to the leased asset for which the private company provides an explicit guarantee or collateral does not exceed the value of the leased asset at inception of such guarantee.
2.4.20.20. The following illustration depicts a common control leasing arrangement:

![Diagram of common control leasing arrangement]

Question 2.4.20.1: Evaluating Whether Entities Are Under Common Control in Applying ASU 2014-07

How should a private company lessee determine whether it is under common control with a lessor entity?

**Interpretive Response:** To apply the exemption, a private company lessee and lessor must be under common control. While common control is used in other areas of U.S. GAAP (e.g., business combinations), it is not defined in the Master Glossary. The PCC and FASB decided not to define it in ASU 2014-07, but did indicate they believe common control may exist (for purposes of applying this exemption) in more situations than those cited by the SEC staff in its remarks on EITF Issue No. 02-5, *Definition of “Common Control” in Relation to FASB Statement No. 141*, for which no final consensus was reached.

The SEC staff indicated in its observations on EITF Issue No. 02-5 that common control exists between (or among) separate entities only in the following situations:

- An individual or enterprise holds more than 50% of the voting ownership interest of each entity;
• Immediate family members hold more than 50% of the voting ownership interest of each entity (with no evidence that those family members will vote their shares in any way other than in concert).
  (a) Immediate family members include a married couple and their children, but not the married couple’s grandchildren.
  (b) Entities might be owned in varying combinations among living siblings and their children. Those situations require careful consideration related to the substance of the ownership and decision-making relationships.

• A group of shareholders holds more than 50% of the voting ownership interest of each entity, and contemporaneous written evidence of an agreement to vote a majority of the entities’ shares in concert exists.

The PCC cited as example an entity owned by a grandparent and an entity owned by a grandchild, which could, on the basis of facts and circumstances, be considered as entities under common control for purposes of applying the accounting alternative.

Because the PCC discussion of common control was strictly in the context of applying the practical expedient for common control leasing arrangements between a private company lessee and lessor and was not codified, we believe this guidance generally should not be used when evaluating whether there is common control in other places of the consolidation accounting literature, such as in the application of the related party guidance.

2.4.20.30. Applying the exemption requires that substantially all activities between the private company and lessor must be related to, or supporting, their leasing activities. This criterion allows a private company lessee to apply the alternative even if the lessor entity conducts activities other than leasing to the private company as long as those activities are unrelated to the private company lessee. The following example activities are provided as implementation guidance:

<table>
<thead>
<tr>
<th>Activity</th>
<th>Related to Leasing Activities?</th>
</tr>
</thead>
<tbody>
<tr>
<td>A guarantee or collateral provided by the private company to the lender of a lessor for debt that is secured by the asset(s) leased by the private company</td>
<td>Yes</td>
</tr>
<tr>
<td>A joint and several liability arrangement for debt of the lessor, for which the private company is one of the obligors, that is secured by the asset(s) leased by the private company</td>
<td>Yes</td>
</tr>
<tr>
<td>Activity</td>
<td>Related to Leasing Activities?</td>
</tr>
<tr>
<td>------------------------------------------------------------------------</td>
<td>-------------------------------</td>
</tr>
<tr>
<td>Paying property taxes, negotiating the financing, and maintaining the asset(s) leased by the private company</td>
<td>Yes</td>
</tr>
<tr>
<td>Paying income taxes of the lessor when the only asset it owns is being leased either by only the private company or by both the private company and an unrelated party</td>
<td>Yes</td>
</tr>
<tr>
<td>Paying income taxes of the lessor on income generated by an asset that is not being leased by the private company</td>
<td>No</td>
</tr>
<tr>
<td>Purchase commitment (other than for the acquisition, or the support, of the leased asset)</td>
<td>No</td>
</tr>
</tbody>
</table>

**Question 2.4.20.2: Meaning of Substantially All of the Activities in Applying ASU 2014-07**

How should a private company lessee determine whether substantially all of the activities between the two entities are related to (or in support of) leasing activities between those two entities in ASC subparagraph 810-10-15-17A(c)?

**Interpretive Response:** Determining whether substantially all of the activities between the two entities are related to (or in support of) leasing activities between those two entities requires judgment and consideration of all relevant facts and circumstances. It is important to note that this evaluation relates solely to determining that the activities between the two entities are related to (or in support of) leasing activities between those two entities. The PCC considered that, generally, a greater level of activity by the lessor entity unrelated to the private company lessee would decrease the likelihood of consolidation under the VIE model, and therefore the lessor entity is permitted to conduct activities other than leasing to the private company lessee as long as those activities are unrelated to the private company lessee. The implementation guidance of ASU 2014-07 also provides examples of activities that are related to, and not related to, leasing activities. See paragraph 2.4.20.30. We believe an entity’s evaluation of this condition in ASC subparagraph 810-10-15-17A(c) should be consistent with its evaluation of whether substantially all of the activities of an entity either involve or are conducted on behalf of the variable interest holder and its related parties for purposes of the condition in ASC subparagraph 810-10-15-17(d)(2) and with its evaluation of whether substantially all of an entity’s activities either involve or are conducted on behalf of the variable interest holder when it has disproportionately few voting rights, as required by ASC subparagraph 810-10-15-14(c)(2) for purposes of evaluating whether the entity is a VIE. See
Consolidation of Variable Interest Entities, Section 2

Question 4.2.80.2 for considerations that we believe should be included in the analysis.

Question 2.4.20.3: Reassessment of Whether the Principal Amount of the Obligation Exceeds the Value of the Leased Asset

After the initial assessment made at inception of the guarantee or collateral arrangement, should a private company lessee continuously reassess whether the principal amount of the obligation of a guarantee or collateral arrangement exceeds the value of the asset leased by the private company from the lessor legal entity in accordance with ASC subparagraph 810-10-15-17A(d)?

**Interpretive Response:** The PCC added the condition in ASC subparagraph 810-10-15-17A(d) to mitigate off-balance sheet structuring opportunities. A private company lessee assesses this condition at inception and only needs to reassess it if the lessor entity subsequently refinances or enters into new obligations that require collateralization and/or a guarantee by the private company lessee. The PCC decided that this condition should be assessed only at the inception of a guarantee or collateral arrangement to prevent a private company lessee from continuously reassessing whether the value of a leased asset exceeds the principal amount of obligations that are guaranteed or collateralized by a private company lessee when the only change is due to a change in the value of the leased asset. See also paragraph 2.4.20.40.

2.4.20.40. ASC Subtopic 810-10 provides illustrations to assist in determining whether a private company lessee is eligible to apply the practical expedient. It also provides example conditions and events that would (or would not) require a private company lessee to reassess whether ASC subparagraph 810-10-15-17A(d) is met to the extent the private company lessee initially applies the practical expedient.
Excerpts from ASC Subtopic 810-10

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

(a) Common control leasing arrangement with no leasing or other activities with unrelated parties (Example 6)
(b) Common control leasing arrangement with additional leasing activities with unrelated parties (Example 7)
(c) Common control leasing arrangement with additional activities other than leasing or for the support of leasing (Example 8).

55-205AK Examples 6 through 8 share all of the following assumptions:

(a) The sole owner of Manufacturing Entity (a private company) is also the sole owner of Lessor Entity.
(b) Manufacturing Entity has pledged its assets as collateral for Lessor Entity’s mortgage.
(c) The common owner of both entities has provided a guarantee of Lessor Entity’s mortgage as required by the lender.
(d) Manufacturing Entity leases its manufacturing facility from Lessor Entity.
(e) The value of the manufacturing facility leased by Manufacturing Entity exceeds the principal amount of Lessor Entity’s mortgage at inception of the mortgage.
(f) Manufacturing Entity has elected to apply the accounting alternative described in paragraph 810-10-15-17A.

Example 6: Common Control Leasing Arrangement with No Leasing or Other Activities with Unrelated Parties

55-205AL Lessor Entity owns no assets other than the manufacturing facility being leased to Manufacturing Entity. Manufacturing Entity pays property taxes on behalf of Lessor Entity and maintains the manufacturing facility. Therefore, Manufacturing Entity meets all four criteria in paragraph 810-10-15-17A and, as a result of its elected accounting policy, would apply the accounting alternative to Lessor Entity based on the following:

(a) Manufacturing Entity and Lessor Entity are under common control.
(b) Manufacturing Entity has a lease arrangement with Lessor Entity.
(c) Substantially all the activities between Manufacturing Entity and Lessor Entity are related to the lease of the manufacturing facility to Manufacturing Entity. Providing collateral, paying property taxes, and maintaining the manufacturing facility are considered to be leasing
activities between Manufacturing Entity and Lessor Entity as described in paragraph 810-10-55-9.

(d) The value of the manufacturing facility leased by Manufacturing Entity exceeds the principal amount of Lessor Entity’s mortgage at inception of the mortgage.

55-205AM If in two years the value of the manufacturing facility declines below the principal amount of the mortgage, Manufacturing Entity would continue to apply this accounting alternative (assuming no other changes have occurred) because the manufacturing facility met criterion (d) in paragraph 810-10-15-17A at inception of the arrangement.

55-205AN If Lessor Entity refines or enters into a new obligation that requires collateralization or a guarantee by Manufacturing Entity, then Manufacturing Entity would be required to reassess whether criterion (d) in paragraph 810-10-15-17A is met at the inception of the new obligation. For example, if Lessor Entity refinances the mortgage (collateralized by assets of Manufacturing Entity) and the new principal balance of the mortgage exceeds the value of the manufacturing facility, then the arrangement would no longer meet criterion (d). Not meeting the criteria to qualify for the accounting alternative does not automatically result in consolidation. Instead, Lessor Entity will need to be evaluated under this Topic, including VIE guidance, for consolidation and related disclosure requirements.

Example 7: Common Control Leasing Arrangement with Additional Leasing Activities with Unrelated Parties

55-205AO Manufacturing Entity leases 3 of the 10 floors of the manufacturing facility from Lessor Entity. Lessor Entity leases the remaining seven floors of the same manufacturing facility to unrelated parties. Manufacturing Entity continues to pledge its assets as collateral for the mortgage that financed the purchase of the entire manufacturing facility (that is, all 10 floors). In this Example, Manufacturing Entity meets all four criteria in paragraph 810-10-15-17A and, as a result of its elected accounting policy, would apply the accounting alternative to Lessor Entity based on the following:

(a) Manufacturing Entity and Lessor Entity are under common control.

(b) Manufacturing Entity has a lease arrangement with Lessor Entity.

(c) Substantially all the activities between Manufacturing Entity and Lessor Entity are related to the lease of the manufacturing facility to Manufacturing Entity, even though part of the manufacturing facility is also leased to unrelated parties.

(d) The value of the manufacturing facility leased by Manufacturing Entity exceeds the principal amount of Lessor Entity’s mortgage at inception of the mortgage.

55-205AP Subsequently, Lessor Entity purchases an additional facility that is leased only to unrelated parties. The value of the new facility is significant to
Lessor Entity, and the mortgage on the additional facility requires a guarantee by Manufacturing Entity. Under these circumstances, Manufacturing Entity failed to meet criterion (c) in paragraph 810-10-15-17A to qualify for the accounting alternative when the guarantee is executed and leasing activity with unrelated parties commenced. Manufacturing Entity is engaging in substantial activity outside its leasing activity with Lessor Entity by providing a guarantee on a mortgage secured by an asset that is not being leased by Manufacturing Entity. Not meeting the criteria to qualify for the accounting alternative does not automatically result in consolidation. Instead, Lessor Entity will need to be evaluated under this Topic, including VIE guidance, for consolidation and related disclosure requirements.

Example 8: Common Control Leasing Arrangement with Additional Activities Other Than Leasing or for the Support of Leasing

55-205AQ Lessor Entity manufactures cosmetics products in another facility that is unrelated to the operations of Manufacturing Entity. There is no mortgage associated with this additional facility, and Manufacturing Entity does not provide collateral or guarantee any obligations related to the cosmetics business. In this Example, Manufacturing Entity meets all four criteria in paragraph 810-10-15-17A and, as a result of its elected accounting policy, would apply the accounting alternative to Lessor Entity based on the following:

(a) Manufacturing Entity and Lessor Entity are under common control.
(b) Manufacturing Entity has a lease arrangement with Lessor Entity.
(c) Substantially all the activities between Manufacturing Entity and Lessor Entity are related to the lease of the manufacturing facility to Manufacturing Entity.
(d) The value of the manufacturing facility leased by Manufacturing Entity exceeds the principal amount of Lessor Entity’s mortgage at inception of the mortgage. There is no obligation associated with the purchase of the cosmetic facility.

55-205AR If there is a mortgage on Lessor Entity’s cosmetics facility that requires Manufacturing Entity to provide collateral and/or a guarantee, then Manufacturing Entity may not apply this accounting alternative to the Lessor Entity because it would not meet criterion (c) in paragraph 810-10-15-17A. A purchase of cosmetics from Lessor Entity by Manufacturing Entity also would require an evaluation of whether criterion (c) of paragraph 810-10-15-17A is met. Not meeting the criteria to qualify for the accounting alternative does not automatically result in consolidation. Instead, Lessor Entity will need to be evaluated under this Topic, including VIE guidance, for consolidation and related disclosure requirements.
2.4.30. Required Disclosures When Applying the PCC Alternative

2.4.30.10. See Subsection 9.3 for a discussion of the relevant disclosures that a private company lessee should provide when it applies the PCC alternative on common control leasing arrangements.

2.4.40. Effective Date and Transition

2.4.40.10. Private company lessees may elect the exemption at the beginning of any annual reporting period but must apply it retrospectively. Private company lessees electing the exemption for the first time may do so without assessing preferability under ASC Topic 250, *Accounting Changes and Error Corrections*.

2.4.40.20. The transition provisions for a private company lessee that elects the exemption and as a result deconsolidates a VIE are similar to the transition provisions for a deconsolidation of a VIE provided in ASU 2015-02. See Subsection 10.2 for additional details.
3. Variable Interests

3.1. IDENTIFYING A VARIABLE INTEREST

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3.1.30. Terms of the Interests Issued

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EQUITY INVESTMENTS

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Excerpt from ASC Section 810-10-20

Variable Interests

The investments or other interests that will absorb portions of a variable interest entity’s (VIE’s) expected losses or receive portions of the entity’s expected residual returns are called variable interests. Variable interests in a VIE are contractual, ownership, or other pecuniary interests in a VIE that change with changes in the fair value of the VIE’s net assets exclusive of variable interests. Equity interests with or without voting rights are considered variable interests if the legal entity is a VIE and to the extent that the investment is at risk as described in paragraph 810-10-15-14. Paragraph 810-10-25-55 explains how to determine whether a variable interest in specified assets of a legal entity is a variable interest in the entity. Paragraphs 810-10-55-16 through 55-41 describe various types of variable interests and explain in general how they may affect the determination of the primary beneficiary of a VIE.

3.1.10.10. As defined, the term variable interests refers to interests through which various parties involved with a VIE share in its economic risks and rewards (i.e., the VIE’s variability). Although the definition refers to interests in VIEs, the entity to which the interest relates need not be a VIE to establish that the interest is a variable interest. The key feature that distinguishes a variable interest from
other interests in an entity is that a variable interest absorbs portions of the entity’s expected losses or expected residual returns (i.e., the interest changes with changes in the fair value of the entity’s net assets exclusive of variable interests). However, the consolidation and disclosure requirements that apply to a variable interest depend on whether the variable interest is in a voting interest entity or a VIE.

3.1.10.20. ASC Section 810-10-20 defines variable interests very broadly, as they may represent contractual; ownership; or other economic, monetary, or financial interests in an entity that change with changes in the fair value of the entity’s net assets (excluding the variable interests). Consequently, an enterprise that has any variable interest in a VIE ordinarily must assess whether its involvement requires consolidation under ASC Subtopic 810-10, Consolidation - Overall. That involvement may include, among other things, (a) lending to the entity, (b) investing in equity (voting or nonvoting) of the entity, (c) issuing guarantees related to the assets or liabilities of the entity, or both, (d) retaining a beneficial interest in (or providing financial support for) assets transferred or sold to the entity, (e) managing the assets of the entity or providing other services to the entity, (f) leasing assets to or from the entity, or (g) entering into a derivative contract with the entity.

3.1.10.30. To determine whether an interest held by an enterprise will absorb expected losses or expected residual returns (i.e., economic risks and rewards or variability) of another entity, the specific risks that the entity was designed to create and distribute to its interest holders must be identified. The FASB developed a framework to promote a consistent approach to identifying variable interests. The by design approach, as described in ASC paragraph 810-10-25-22, is a two-step process that requires enterprises to qualitatively assess an entity’s design by:

(1) Analyzing the nature of the entity’s risks; and
(2) Determining the entity’s purpose as well as the variability it is designed to create and distribute to its interest holders.

Excerpts from ASC Subtopic 810-10

Determining the Variability to Be Considered

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

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

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

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

(a) Step 1: Analyze the nature of the risks in the legal entity (see paragraphs 810-10-25-24 through 25-25).

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

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

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

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

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

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

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

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

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

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

Implementation Guidance and Illustrations

Identifying Variable Interests

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

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

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

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

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

3.1.10.40. After identifying an entity’s risks and the variability it was designed to create and distribute to its interest holders, the enterprise should then identify specific variable interests in that entity. That is, it should identify those interests that will absorb or receive the entity’s expected losses and residual returns. Interests that create rather than absorb or receive an entity’s variability are not considered variable interests because they do not absorb the risks that the entity was designed to distribute to its interest holders. Additionally, interests that absorb variability that the entity was not designed to create and distribute to its interest holders are generally not considered variable interests.
3.1.20. Identifying the Risks That an Entity Was Designed to Create and Distribute

3.1.20.10. The first step of the by design approach is to identify the nature of the entity’s risks. As described in ASC paragraph 810-10-25-24, examples of risks may include, but are not limited to:

- Credit risk, such as the risk that the entity will default on all or part of its obligations;
- Interest rate risk, such as the risk that the interest payments on a floating-rate financial instrument will vary or that the fair value of a fixed-rate financial instrument will change based on interest-rate fluctuations (the cash flows on fixed-rate instruments may also vary due to prepayment risk);
- Foreign currency exchange risk, such as the risk that the cash flows from a fixed price sales contract denominated in a foreign currency will fluctuate because of changes in the rate at which the foreign currency is converted into the entity’s functional currency;
- Price risk, such as the risk of fluctuations in the prices of assets (e.g., real estate, equity instruments, or commodities used in producing inventories); and
- Operations risk, such as the risk that the entity’s labor costs or other operating costs will fluctuate.

3.1.20.20. The objective of the second step of the by design approach is to determine which of the risks identified in the first step the entity was designed to create and pass along to its interest holders. All relevant facts and circumstances, including but not limited to the following factors, should be considered when performing the second step:

- The entity’s activities;
- The terms of its contracts;
- The nature of the interests it has issued;
- How the interests it has issued were marketed to and negotiated with potential investors; and
- Which parties participated significantly in the entity’s design or redesign.

3.1.20.30. To assist enterprises in identifying the variability that an entity was designed to create and distribute to its interest holders, ASC paragraph 810-10-25-30 lists the following considerations that may be helpful in determining whether or not an interest is a variable interest.

- The terms of the interests issued;
- Subordination;
(c) Certain interest rate risk; and
(d) Certain derivative instruments.

3.1.30. Terms of the Interests Issued

Excerpt from ASC Subtopic 810-10

Terms of Interests Issued

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

3.1.30.10. If the terms of an interest transfer some of the risks that an entity was designed to create to the interest holder(s), it may be a variable interest. ASC Subtopic 810-10 maintains that the characterization of a contract or arrangement under generally accepted accounting principles may not necessarily depict whether the contract or arrangement transfers to the counterparty some of the risks (variability) that the entity was designed to distribute to its variable interest holders.

Question 3.1.30.1: Consideration of the Accounting for an Entity’s Interests or Their Legal Form When Identifying the Risks That the Entity Is Designed to Create

When identifying the risks that an entity is designed to create and distribute to its interest holders, should an enterprise identify those risks based solely on the legal form or accounting for the interests in the entity?

Interpretive Response: No. ASC paragraphs 810-10-25-26 and 25-31 indicate that the role of a contract or arrangement in the design of an entity and whether the terms of the entity’s interests, regardless of their legal form or accounting, transfer a portion of the risk and/or return of certain of the entity’s assets or operations would determine whether the interest is a variable interest in the entity. Examples 3.1 and 3.2 illustrate this analysis.

Example 3.1.30.1: Transfer of Price Risk

XYZ Inc. is an entity established by a global snowmobile manufacturer (Manufacturer) and a third-party investor to sell snowmobiles to customers in Saskatchewan. On its formation, XYZ entered into an agreement to purchase snowmobiles at a fixed price from Manufacturer; however, XYZ may return unsold snowmobiles to Manufacturer at any time for the price paid.
Manufacturer has no other involvement with XYZ. In this scenario, Manufacturer is exposed to inventory price risk with respect to XYZ’s unsold snowmobiles. Although it is unlikely that Manufacturer would record sales of the snowmobiles after applying the guidance in ASC Subtopic 470-40, Debt - Product Financing Arrangements, in our view it is appropriate to consider inventory price risk as a risk that XYZ is designed to create and pass along to its interest holders, including Manufacturer.

It is clear in this example that XYZ is serving as a source of financing for Manufacturer. Without considering inventory price risk to be a risk that XYZ is designed to create and pass along to its interest holders, Manufacturer would not have a variable interest in XYZ and would not be subject to the VIE consolidation requirements in ASC Subtopic 810-10. These circumstances together with the fixed-price purchase agreement support the view that XYZ is designed to create and pass along inventory price risk to its interest holders. Based on this analysis of XYZ’s design, Manufacturer has a variable interest that exposes it to inventory price risk of XYZ through XYZ’s option to put (sell) unsold snowmobiles to Manufacturer for a fixed price.

Example 3.1.30.2: Transfer of Receivables to a Special-Purpose Entity

ABC Inc., a manufacturing entity, transfers $1,000 of customer receivables to SPE, a special-purpose financing vehicle. Under the terms of the transaction, ABC (1) receives cash of $800 funded by SPE’s issuance of senior beneficial interests, (2) retains a $200 subordinated beneficial interest in the transferred receivables, and (3) receives a fixed-price call option on the receivables transferred. Because of the fixed-price call option, the transaction is accounted for as a secured borrowing under the requirements of ASC Topic 860, Transfers and Servicing. Accordingly, ABC does not derecognize the customer receivables from its balance sheet and, because ASC Topic 860 is applied symmetrically by transferors and transferees, SPE records a receivable from ABC rather than customer receivables in its balance sheet. Although for accounting purposes SPE recognizes a receivable from ABC rather than the individual customer receivables, it is not exposed to ABC’s credit risk. From an economic perspective, the beneficial interest holders are exposed to the variability of the transferred customer receivables rather than ABC’s credit risk. Based on the guidance in ASC paragraph 810-10-25-31, we believe that it would be inappropriate for ABC to conclude that it has no potential variable interest in SPE on the basis that the customer receivables were not transferred for accounting purposes.
### 3.1.40. Subordination

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<td><strong>Subordination</strong></td>
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<td><strong>25-32</strong> For legal entities that issue both senior interests and subordinated interests, the determination of which variability shall be considered often will be affected by whether the subordination (that is, the priority on claims to the legal entity’s cash flows) is substantive. The subordinated interest(s) (as discussed in paragraph 810-10-55-23) generally will absorb <strong>expected losses</strong> prior to the senior interest(s). As a consequence, the senior interest generally has a higher credit rating and lower interest rate compared with the subordinated interest. The amount of a subordinated interest in relation to the overall expected losses and residual returns of the legal entity often is the primary factor in determining whether such subordination is substantive. The variability that is absorbed by an interest that is substantively subordinated strongly indicates a particular variability that the legal entity was designed to create and pass along to its interest holders. If the subordinated interest is considered equity-at-risk, as that term is used in paragraph 810-10-15-14, that equity can be considered substantive for the purpose of determining the variability to be considered, even if it is not deemed sufficient under paragraphs 810-10-15-14(a) and 810-10-25-45.</td>
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| 3.1.40.10. | Entities are often formed with a capital structure that comprises both senior and subordinate interests. An interest generally would be expected to absorb or receive greater variability if it is more subordinated than the entity’s other interests. Conversely, senior interests generally would be expected to receive less variability than the entity’s subordinated interests. For example, senior debt instruments with fixed interest rates or other fixed returns normally would absorb little variability if there is a substantive level of subordinated interests to absorb the entity’s expected variability. When determining whether an entity’s subordination is substantive (e.g., that an entity is designed to create and pass along credit risk to its interest holders), an enterprise should consider all relevant quantitative and qualitative factors including, but not limited to: |
| **Variability expected to be absorbed by an entity’s interests.** If an entity’s subordinated interests appear sufficient to absorb the expected variability (e.g., expected losses and residual returns), it is likely that the entity’s subordination is substantive. |
| **Credit ratings of the entity’s interests.** Wide dispersion of an entity’s debt credit ratings is a positive indicator that subordination is substantive. For example, subordination may be substantive if an entity has five tranches of debt with five different credit ratings rather than five debt tranches with only two credit ratings, as it indicates that the more subordinate interests (those with worse lower ratings) are more likely to absorb variability. |
• **Magnitude of the entity’s subordinate interests.** Entities with higher percentages of equity to debt and subordinated debt to senior debt may have a more substantive level of subordination.

• **Interest rates and yields on an entity’s interests.** An entity with a subordinated capital structure may have several tranches of debt outstanding. Generally, the senior tranches will have a lower interest rate than the subordinated tranches, as the holders of subordinated tranches are compensated for bearing a greater level of credit risk. Accordingly, dispersion among the interest rates on an entity’s debt issuances may be a positive indicator that the subordination is substantive in nature.

• **Types of investors and how the interests were marketed.** Understanding these factors and obtaining this information may provide an enterprise with insights into the design of, and subordination within, an entity’s capital structure.

3.1.40.20. Equity interests not considered at risk under ASC subparagraph 810-10-15-14(a) may not provide evidence that an entity’s subordination is substantive. For example, equity that may be put (sold) back to the entity at its purchase price may indicate that the entity’s subordinated capital structure is not substantive because this interest would likely not be available to absorb variability (losses).

3.1.40.30. There also may be circumstances in which the equity at risk is not considered sufficient under ASC subparagraph 810-10-15-14(a), but the subordination of the entity’s capital structure is deemed to be substantive. For example, assume an entity has assets of $1,000, senior debt of $800, subordinated debt of $100, and equity of $100. If the entity’s losses were expected to exceed $100, the equity would be insufficient under ASC subparagraph 810-10-15-14(a), but the subordination of the capital structure as a whole (equity and debt interests) may be substantive. Before concluding on whether an entity’s subordination is substantive, all relevant facts and circumstances should be considered.

3.1.50. **Interest Rate Risk**

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

3.1.50.10. Interest rate risk generally has a greater effect on the senior variable interests (e.g., senior debt) than it does on the subordinated interests in an entity given the absolute amounts of those interests. In addition, interest rate fluctuations are driven principally by macro-economic market forces and movements rather than entity-specific factors. Before FASB Accounting Standards Update No. 2009-17 (ASU 2009-17), Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities (originally issued as FASB Statement No. 167, Amendments to FASB Interpretation No. 46(R) (Statement 167)) amended the VIE consolidation requirements, considering interest rate risk to be a creator of variability in a VIE significantly increased the likelihood that a senior variable interest holder rather than a subordinated variable interest holder would be required to consolidate the VIE. This result appeared to be contradictory to the objectives of the VIE consolidation requirements. Accordingly, we believe interest rate risk often should be excluded from the variability an entity was designed to create and distribute to its interest holders. We believe this continues to be appropriate even though ASU 2009-17 reduced the likelihood that a senior variable interest holder rather than a subordinated variable interest holder would be required to consolidate a VIE.

3.1.50.20. Sometimes, however, an entity may be designed to both create and pass along interest rate risk to its interest holders. For example, an entity holding fixed-rate investments that will have to be sold before their maturity to satisfy the entity’s obligations may be designed to create and distribute interest rate risk. On the other hand, if the fixed-rate investments are expected to be held by an entity until maturity, interest rate risk should typically be excluded as a source of variability to be evaluated. When an entity is designed to create and pass along interest rate risk to its variable interest holders, we believe the method of measuring the entity’s variability (i.e., based on changes in fair value or based on changes in cash flows) generally should be the method that results in the greatest attribution of variability to the entity’s subordinated interests.

**Question 3.1.50.1: Whether to Separately Evaluate Interest Rate Risk and Prepayment Risk**

Should interest rate risk and prepayment risk be considered separately when evaluating the nature of the risks an entity was designed to create and pass along to its variable interest holders?

**Interpretive Response:** We believe that prepayment risk and interest rate risk generally should be considered together, particularly if changes in interest rates give rise to variable cash flows. In other words, entities designed to create and distribute prepayment risk are generally designed to create and distribute interest rate risk generated by periodic cash payments (i.e., changes in the interest rate between payment dates). However, we believe the variability of such entities generally should be measured based on changes in
fair value rather than changes in cash flows. See ASC paragraphs 810-10-55-59 through 55-64 and 55-68 through 55-70 for examples of situations in which it is appropriate to consider interest rate risk a creator of variability in an entity.

3.1.60. Derivative Instruments

Excerpts from ASC Subtopic 810-10

Certain Derivative Instruments

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

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

(a) Its underlying is an observable market rate, price, index of prices or rates, or other market observable variable (including the occurrence or nonoccurrence of a specified market observable event).

(b) The derivative counterparty is senior in priority relative to other interest holders in the legal entity.

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

Implementation Guidance and Illustrations

Forward Contracts

55-27 Forward contracts to buy assets or to sell assets that are not owned by the VIE at a fixed price will usually expose the VIE to risks that will increase the VIE’s expected variability. Thus, most forward contracts to buy assets or to sell assets that are not owned by the VIE are not variable interests in the VIE.
**55-28** A forward contract to sell assets that are owned by the VIE at a fixed price will usually absorb the variability in the fair value of the asset that is the subject of the contract. Thus, most forward contracts to sell assets that are owned by the VIE are variable interests with respect to the related assets. Because forward contracts to sell assets that are owned by the VIE relate to specific assets of the VIE, it will be necessary to apply the guidance in paragraphs 810-10-25-55 through 25-56 to determine whether a forward contract to sell an asset owned by a VIE is a variable interest in the VIE as opposed to a variable interest in that specific asset.

**Other Derivative Instruments**

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

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

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

### 3.1.60.10

Before evaluating whether a derivative instrument entered into with an entity is a variable interest, the by design approach requires enterprises to understand the nature of the variability that the entity was designed to create and pass along to its variable interest holders. In certain situations, derivative instruments may be considered variable interests if they absorb variability associated with the risks that the VIE was designed to distribute. Conversely, a derivative instrument that contributes to the VIE’s expected variability (i.e., because the derivative contract is a net creator rather than an absorber of variability) would generally not be considered a variable interest. All relevant facts and circumstances should be considered when evaluating whether a derivative contract is a variable interest.

### 3.1.60.20

Due to the operational burden many enterprises would experience if they were required to determine whether each derivative contract entered into represents a variable interest, the FASB provided a form of relief within ASC paragraph 810-10-25-35 for unsubordinated derivative contracts (e.g., *plain vanilla* interest rate swaps or foreign currency swaps) by indicating that the following characteristics, if both are present, are strong indicators that a
derivative instrument is a creator of variability rather than an absorber of variability (i.e., the derivative contract is not a variable interest):

(1) 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); and

(2) The derivative counterparty is senior in priority relative to the other interest holders in the entity (i.e., they are exposed to minimal credit risk).

**Question 3.1.60.1: Contracts Meeting the Definition of a Derivative**

Must a contract meet the definition of a derivative under ASC Topic 815, *Derivatives and Hedging*, for the guidance in ASC paragraph 810-10-25-35 on evaluating whether the contract is a creator of variability to apply?

**Interpretive Response:** Yes. We understand that the FASB staff believes enterprises should first evaluate whether the contract meets the definition of a derivative under ASC paragraph 815-10-15-83 before applying the guidance in ASC paragraph 810-10-25-35. Derivative instruments for purposes of this analysis also include those that meet ASC Topic 815’s definition of a derivative, but are excluded from the scope of ASC Topic 815, under ASC paragraph 815-10-15-13.

**Question 3.1.60.2: Evaluating Whether a Derivative Is Strongly Indicated as a Creator of Variability**

What should be considered when evaluating whether both conditions in ASC paragraph 810-10-25-35 that strongly indicate a derivative is a creator of variability are met for a particular derivative contract?

**Interpretive Response:** For the underlying to be a market observable variable, we believe it should derive from sources external to the entity or any of its interest holders (e.g., LIBOR- or Treasury-based interest rate indices, the Fed Funds Effective Swap Rate, etc.). We also believe that the underlying should have sufficient activity (consistent with a high level of liquidity in the ASC Topic 815 concept of readily convertible) to be considered market observable. A single market quote for an underlying in certain instances may not provide sufficient evidence that the underlying is market observable, even if it is obtained from external sources. It should be noted that market observable for purposes of this evaluation is not analogous to the concept of observable inputs within ASC Topic 820, *Fair Value Measurement*. Under ASC Topic 820, observable inputs are not limited to those in an active and liquid market. Significant professional judgment is necessary in evaluating whether the underlying is market observable when performing this assessment.
For a derivative counterparty to be considered senior in priority relative to the other interest holders, we believe that it must be at least *pari passu* with the entity’s most senior interest(s). We do not believe this condition requires all other interest holders to be subordinate to the derivative counterparty.

**3.1.60.30.** Often, derivative contracts meeting both conditions in ASC paragraph 810-10-25-35 are not considered variable interests in an entity. However, while the presence of these factors may provide strong indicators that a derivative is a creator of variability, simply meeting both conditions does not exempt a derivative contract from being considered a variable interest. For example, if the changes in the fair value or cash flows of the derivative instrument are expected to offset all or substantially all of the risk and/or return related to a majority of the assets of the entity, the by design approach requires the design of the entity to be further evaluated to determine whether the derivative contract is a variable interest. If the entity was designed to create and distribute certain risks to the derivative counterparty, the derivative would likely be deemed to be a variable interest.

**Question 3.1.60.3: Meaning of the Phrase *Essentially All* in ASC Paragraph 810-10-25-36**

How should an enterprise interpret the phrase *essentially all* when considering the guidance in ASC paragraph 810-10-25-36?

**Interpretive Response:** When evaluating whether a derivative instrument offsets essentially all of the risk in an entity, the enterprise should consider the magnitude of the total risk being offset, rather than whether the reporting entity offsets a certain percentage or portion of each type of the entity’s risk. Determining whether a derivative offsets essentially all of an entity’s aggregate risk requires management to exercise judgment and consider all relevant facts and circumstances. We understand based on informal discussions with the FASB staff that the phrase *essentially all* is generally intended to mean the inverse of a trivial amount. The phrase *essentially all* also is used in ASC paragraph 810-10-25-58 in the context of whether a silo exists within a VIE. Under the guidance in that paragraph, a silo does not exist when an asset or group of assets of an entity is financed 100% with nonrecourse debt but parties other than the lender (e.g., equity investors) are entitled to the residual cash flows from the asset or group of assets.

For example, assume an entity’s assets (excluding derivative instruments) are exposed to credit risk and interest rate risk. Interest rate risk comprises over 99% of the total risk in the entity. Also assume that an enterprise is the counterparty to a derivative instrument with the entity that offsets all of the entity’s interest rate risk, but none of the credit risk. In this situation, assuming no other arrangements exist, we believe the derivative instrument may be deemed to offset essentially all of the overall risk in the entity even though it does not offset credit risk. However, the determination of whether the derivative would be considered a variable interest in the entity depends in part
on whether the entity is designed to create and distribute interest rate risk to its interest holders.

### 3.1.60.40
The following table provides examples of common derivative instruments and whether they generally absorb fair value and/or cash flow variability. As stated above, derivative contracts that do not absorb an entity’s variability are not variable interests while those that do may or may not be considered variable interests after a careful evaluation of the guidance in ASC paragraphs 810-10-25-35 and 25-36:

<table>
<thead>
<tr>
<th>Derivative Type</th>
<th>Derivative Description</th>
<th>Nature of Variability Absorbed (if any)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Written put or guarantee</td>
<td>Counterparty has the right to sell assets to the VIE at a price other than their fair value or to receive protection against specified risks from the VIE</td>
<td>Written put or guarantee contracts generally create rather than absorb variability</td>
</tr>
<tr>
<td>Purchased put or guarantee</td>
<td>VIE has the right to sell assets to the counterparty at a price other than their fair value or to receive protection against specified risks from the counterparty</td>
<td>Purchased put or guarantee contracts may absorb fair value and/or cash flow variability</td>
</tr>
<tr>
<td>Written call</td>
<td>Counterparty has the right to purchase assets from the VIE at a price other than their fair value</td>
<td>Written call contracts may absorb fair value and/or cash flow variability</td>
</tr>
<tr>
<td>Purchased call</td>
<td>VIE has the right to purchase assets from the counterparty at a price other than their fair value</td>
<td>Purchased call contracts generally create rather than absorb variability</td>
</tr>
<tr>
<td>Forward purchase</td>
<td>VIE has agreed to purchase assets from the counterparty at a fixed price at a future date</td>
<td>Forward purchase contracts generally create rather than absorb variability</td>
</tr>
<tr>
<td>Derivative Type</td>
<td>Derivative Description</td>
<td>Nature of Variability Absorbed (if any)</td>
</tr>
<tr>
<td>-------------------------</td>
<td>----------------------------------------------------------------------------------------</td>
<td>--------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Forward sale</td>
<td>Counterparty has agreed to purchase assets from the VIE at a fixed price at a future date</td>
<td>Forward sale contracts may absorb fair value and/or cash flow variability</td>
</tr>
<tr>
<td>Total return swap (in)</td>
<td>Counterparty pays the total return related to a specific asset or asset group to the VIE and the VIE pays the counterparty a fixed return based on a notional amount</td>
<td>Total return swap (in) contracts generally create rather than absorb variability</td>
</tr>
<tr>
<td>Total return swap (out)</td>
<td>VIE pays the total return related to a specific asset or asset group to the counterparty and the counterparty pays the VIE a fixed return based on a notional amount</td>
<td>Total return swap (out) contracts may absorb fair value and/or cash flow variability</td>
</tr>
<tr>
<td>Interest rate swap (fixed for floating)</td>
<td>VIE pays interest to the counterparty based on a fixed rate and the counterparty pays interest to the VIE based on a variable rate</td>
<td>Interest rate swap contracts generally create rather than absorb variability</td>
</tr>
<tr>
<td>Interest rate swap (floating for fixed)</td>
<td>Counterparty pays interest to the VIE based on a fixed rate and the VIE pays interest to the counterparty based on a variable rate</td>
<td>Interest rate swap contracts generally create rather than absorb variability</td>
</tr>
</tbody>
</table>
Example 3.1.60.1: Identifying Variable Interests in a Common Synthetic CDO Structure

In a common synthetic CDO structure, an entity issues multiple classes (e.g., senior, subordinated, junior) of beneficial interests to fund the purchase of highly rated debt securities. The subordination in this entity is considered substantive because the various classes of beneficial interests bear different rates of interest and have credit ratings that are commensurate with the entity’s risk of default.

Upon formation, the entity also writes a credit default swap that is indexed to a portfolio of commercial or corporate debt instruments (underlying assets). Under the terms of the derivative arrangement, the credit default swap counterparty is senior in priority to any of the entity’s beneficial interest holders. Additionally, if a credit event occurs with respect to the underlying assets, the derivative’s terms would require the CDO entity to either (a) purchase the underlying assets at par or (b) pay the counterparty the amount of the decrease in value of the underlying assets. In return, the counterparty makes periodic premium payments to the entity. If a credit event occurs with respect to the underlying assets, the CDO entity may be forced to sell its highly-rated debt securities to make payments to the credit default swap counterparty. This may result in the CDO entity having insufficient cash flows to service principal and interest payments on the outstanding beneficial interests.

Because synthetic CDO structures vary in nature, all relevant facts and circumstances should be considered when identifying variable interests in these entities. In this example, the credit default swap written by the entity would typically not be considered a variable interest because it appears to meet both characteristics in ASC paragraph 810-10-25-35 (i.e., credit events would be considered market observable and the counterparty is senior in priority relative to other variable interest holders). Because the credit default swap creates variability (credit risk), it would not be considered a variable interest in the CDO entity. However, the entity’s various classes of beneficial interests would be considered variable interests because they each absorb some of the variability that the entity was designed to create and distribute to its interest holders (i.e., credit risk on the reference assets).

Question 3.1.60.4: Notional Amount Less Than Half the Fair Value of a VIE’s Assets

If the notional amount of an interest rate swap is less than half the fair value of an entity’s assets, would it be considered a variable interest in specified assets of the entity?

Interpretive Response: No. Amounts owed by an interest rate swap counterparty are typically general obligations of that entity. Furthermore, payments made by an entity to an interest rate swap counterparty are
generally not dependent on cash flows generated by specified assets of the entity. Accordingly, we believe that an interest rate swap representing a general obligation of the entity is not an interest in specified assets and should be evaluated for purposes of determining whether or not it represents a variable interest under ASC paragraphs 810-10-25-35 and 25-36.

EMBEDDED DERIVATIVES

3.1.60.50. Some assets and liabilities of a VIE have embedded derivatives. As indicated in ASC paragraph 810-10-55-31, embedded derivatives that are clearly and closely related economically to their asset or liability host are not separately evaluated for the purpose of understanding whether the embedded feature represents a variable interest. Other embedded derivatives, whether or not bifurcated and accounted for separately from the host instrument, should be separately evaluated to determine whether they represent a variable interest.

Question 3.1.60.5: Consideration of Embedded Derivatives as Variable Interests

How should embedded derivative features (whether or not bifurcated and accounted for separately from the host instrument) be evaluated to determine whether they are clearly and closely related economically to the host contract?

Interpretive Response: Evaluating whether an embedded derivative feature is clearly and closely related economically to the host contract requires careful consideration of all relevant facts and circumstances that should include the nature and purpose of the embedded feature relative to its host. Where the value of the embedded feature is directly related to the value of the host contract, we believe that the embedded derivative would be considered clearly and closely related for purposes of this analysis. For example, an embedded derivative whose value changes proportionally (i.e., the embedded feature is not leveraged or deleveraged) and is either directly or inversely highly correlated with the value changes of the host contract would generally be considered clearly and closely related economically to the host contract.

We understand that the FASB does not intend the evaluation of whether an embedded feature is a variable interest to be based exclusively on the bifurcation guidance in ASC Topic 815 because that guidance does not always require separation of an embedded derivative that is not clearly and closely related economically to its host. Nevertheless, we believe that the guidance in ASC Topic 815 for determining whether an embedded derivative is clearly and closely related to its host generally is consistent with the guidance in ASC paragraph 810-10-55-31.
Question 3.1.60.6: Note Payable with Embedded Interest Rate Feature

Does an enterprise that borrows funds from an entity (lender) at a variable rate of interest through a note payable have a variable interest in the entity (lender)?

Interpretive Response: Because the interest rate on the note payable is variable, cash payments to the entity (lender) will change depending on movements in the index on which the interest rate feature is based. However, the note payable due to the lender can be viewed as comprising two components: (1) a fixed rate instrument and (2) an embedded interest rate swap that passes the risk associated with changes in the fair value of the lender’s note receivable balance associated with changes in the interest rate to the debtor (reporting enterprise). While it appears that the debtor absorbs variability in the lender’s assets (note receivable) associated with changes in the interest rate index through the embedded interest rate swap feature, we generally believe that interest rate features embedded within debt (or similar) host instruments would be clearly and closely related economically to the host contract. As such, variable rate obligations owed to an entity generally would not be considered variable interests in the entity.

3.1.60.60. The following table provides examples of common embedded derivatives within various host contracts and a brief discussion about whether the embedded features would be evaluated separately to determine whether the embedded derivative is a variable interest.

<table>
<thead>
<tr>
<th>Embedded Feature(s)</th>
<th>Host Contract</th>
<th>Consideration of Whether the Feature Is Clearly and Closely Related Economically to the Host</th>
</tr>
</thead>
<tbody>
<tr>
<td>Call and put features</td>
<td>Equity instrument</td>
<td>Embedded call and put features that require the entity to purchase the instrument at a price other than its fair value or give the holder the right to require the entity to purchase the instrument at a price other than its fair value generally are not clearly and closely related economically to the equity host because the economic characteristics of put and call features differ from those of an equity instrument (e.g., ownership interest in an entity).</td>
</tr>
<tr>
<td>Embedded Feature(s)</td>
<td>Host Contract</td>
<td>Consideration of Whether the Feature Is Clearly and Closely Related Economically to the Host</td>
</tr>
<tr>
<td>--------------------------------------------</td>
<td>---------------</td>
<td>---------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Call and put features</td>
<td>Debt instrument</td>
<td>Embedded call and put features within a debt host generally are considered clearly and closely related economically to the debt host provided that the debt does not have a substantial discount or premium (e.g., zero coupon bonds).</td>
</tr>
<tr>
<td>Interest rate/interest rate index</td>
<td>Debt instrument</td>
<td>Embedded features based on an interest rate or interest rate index generally are considered clearly and closely related economically to the debt host if (1) significant leverage is not involved and (2) the debt cannot be settled so that the investor would not recover substantially all of its investment.</td>
</tr>
<tr>
<td>Other interest rate features (collars, floors, and caps)</td>
<td>Debt instrument</td>
<td>Embedded collars, floors, and caps generally are considered clearly and closely related economically to the debt host provided that (1) no leverage exists and (2) the floor is below and the cap is above the market interest rate at the date of issuance.</td>
</tr>
<tr>
<td>Embedded Feature(s)</td>
<td>Host Contract</td>
<td>Consideration of Whether the Feature Is Clearly and Closely Related Economically to the Host</td>
</tr>
<tr>
<td>----------------------------------------</td>
<td>---------------------</td>
<td>-------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Credit sensitive payment features</td>
<td>Debt instrument</td>
<td>A debtor’s creditworthiness and interest rate on its debt issuances are clearly and closely related. Therefore, features within debt instruments that change the interest rate paid upon a debtor-specific credit event (e.g., credit rating change, event of default, etc.) generally would be considered clearly and closely related economically to the debt host.</td>
</tr>
<tr>
<td>Inflation adjustment features</td>
<td>Debt instrument</td>
<td>Because interest rates and inflation rates in the economy from which the debt has been issued are clearly and closely related economically, embedded inflation-indexed provisions are generally considered clearly and closely related economically to the debt host provided that no leverage factor exists.</td>
</tr>
<tr>
<td>Equity or commodity-indexed features</td>
<td>Debt instrument</td>
<td>Embedded features that change the interest rate paid by the debtor based on changes in the fair value of an equity security, specific commodity, or index thereof generally are not considered clearly and closely related economically to the debt host.</td>
</tr>
<tr>
<td>Equity conversion features</td>
<td>Debt instrument</td>
<td>Embedded features that may permit or require conversion into an equity interest generally are not considered clearly and closely related economically to the debt host.</td>
</tr>
<tr>
<td>Embedded Feature(s)</td>
<td>Host Contract</td>
<td>Consideration of Whether the Feature Is Clearly and Closely Related Economically to the Host</td>
</tr>
<tr>
<td>----------------------------</td>
<td>--------------------</td>
<td>---------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Residual value guarantees</td>
<td>Lease instrument</td>
<td>Residual value guarantees are features embedded in leases that require the lessee to pay the lessor a specified amount if the leased asset is worth less than a predetermined amount at a future date. These features should not be considered clearly and closely related economically to the lease host based on the requirements of ASC paragraph 810-10-55-39 (also see paragraph 3.2.70.10).</td>
</tr>
<tr>
<td>Purchase options</td>
<td>Lease instrument</td>
<td>Embedded purchase options generally provide the lessee with the right to purchase the leased asset from the lessor at a specified date in the future. These features should not be considered clearly and closely related economically to the lease host based on the requirements of ASC paragraph 810-10-55-39 (also see paragraph 3.2.70.10).</td>
</tr>
<tr>
<td>Term-extending features</td>
<td>Lease instrument</td>
<td>Unless the embedded term-extending features are based on market rates, such features generally are not considered clearly and closely related economically to the lease host because they are not economically related to changes in value of the leased asset.</td>
</tr>
</tbody>
</table>
**Embedded Feature(s)** | **Host Contract** | **Consideration of Whether the Feature Is Clearly and Closely Related Economically to the Host**
--- | --- | ---
Inflation-indexed features | Lease instrument | Unless significant leverage is involved, inflation-indexed rental features generally are considered clearly and closely related economically to the lease host.
Contingent rental payment features | Lease instrument | Embedded features that require the lessee to make additional rental payments based on lessee sales or changes in a variable interest rate (e.g., LIBOR) generally would be considered clearly and closely related economically to the lease host.

### 3.1.70. FASB Examples – Determining the Variability to Be Considered

**Excerpt from ASC Subtopic 810-10**

**Example 3: Determining the Variability to Be Considered**

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

(a) Financial VIE primarily financed by fixed-rate debt, holding investments in longer-term fixed-rate debt (Case A)

(b) Financial VIE primarily financed by fixed-rate debt, holding investments in longer-term fixed- and variable-rate debt (with a fixed-rate swap) (Case B)

(c) Financial VIE primarily financed by fixed-rate debt, holding investments in foreign-currency-denominated debt (with a currency swap) (Case C)

(d) Financial VIE primarily financed by floating-rate debt, holding investments in fixed-rate securities (Case D)

(e) Financial VIE financed by credit-linked notes holding highly rated floating-rate investments and a credit default swap (Case E)
(f) Retail-operating VIE (Case F)

(g) Lessor VIE (direct financing lease) with single lessee (operating lease) (Case G)

(h) VIE holding both a fixed-price forward contract to buy and a fixed-price forward contract to sell electricity (Case H).

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

(i) All the entities are presumed to be VIEs.

(j) All variable interests are variable interests in the VIE (as a whole) rather than variable interests in specified assets of the VIE, based on the guidance in paragraphs 810-10-25-55 through 25-59.

(k) A primary beneficiary has not been identified; however, the determination of the primary beneficiary should be made in accordance with the guidance in paragraphs 810-10-25-38A through 25-38G.

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

(l) Step 1: Analyze the nature of the risks in the VIE.

(m) Step 2: Determine the purpose(s) for which the VIE was created and determine the variability the VIE is designed to create and pass along to its interest holders.

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

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

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

(n) Credit risk associated with a possible default by the issuers of the investments in the portfolio with respect to principal and interest payments

(o) Interest rate risk associated with interim changes in the fair value of the fixed-rate periodic interest payments received on the fixed-rate investment portfolio

(p) Interest rate risk associated with changes in cash received upon the sale of fixed-rate investments prior to maturity.

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

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

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

Based on this analysis, it can be determined that the VIE was designed to create and pass along the risks in (a) and (c) in the preceding paragraph to the debt and equity investors, which are the VIE’s variable interest holders.
Case B: Financial VIE Primarily Financed by Fixed-Rate Debt, Holding Investments in Longer-Term Fixed- and Variable-Rate Debt (with a Fixed-Rate Swap)

A VIE is created and financed with $96 of 3-year fixed-rate debt and $4 of equity from investors. The VIE uses the proceeds to purchase $40 of B- and BB-rated fixed-rate securities with contractual maturities ranging from 6 to 8 years and $60 of B- and BB-rated floating-rate securities with contractual maturities ranging from 6 to 8 years (average maturity of 7 years). In addition, the VIE enters into a $60 notional 7-year pay floating and receive fixed interest rate swap with a bank. The swap economically converts the $60 of floating-rate investments to fixed-rate investments of the same average maturity. At the end of three years, all the investments will be sold, and the swap settled in cash, with the net proceeds used, first, to pay the fixed-rate debt holders and, second, to pay the equity holders to the extent proceeds remain. Net amounts payable to the swap counterparty periodically and at the end of three years (if required) take priority over payments made to the debt and equity investors.

The transaction was marketed to potential debt investors as an investment in a portfolio of below-investment-grade fixed-rate and floating-rate investments (with the floating rate swapped for fixed) with a longer weighted-average maturity (including the effect of the swap) than the liabilities and credit support from the equity tranche. The equity tranche was negotiated to absorb the first dollar risk of loss related to credit risk and interest rate risk, and to receive any residual benefit from a favorable change in interest rates or credit risk that affects the proceeds received on the sale of the investments in the portfolio (including settlement of the swap prior to its contractual maturity). The following diagram illustrates this situation.

See Evaluation (paragraphs 810-10-55-63 through 55-64)
55-63 The VIE is exposed to the following risks:

(a) Credit risk associated with a possible default by the issuers of the investments in the portfolio with respect to principal or interest payments

(b) Credit risk associated with a possible default by the swap counterparty with respect to interest payments and the settlement amount, if any, due to the VIE at the end of three years

(c) Interest rate risk associated with changes in the fair value of the fixed-rate periodic interest payments received on the fixed-rate investment portfolio and on the fixed leg of the swap

(d) Interest rate risk associated with changes in the periodic interest payments received on the floating-rate investment portfolio

(e) Interest rate risk associated with changes in cash received upon the sale of fixed-rate investments before maturity

(f) Interest rate risk associated with the amount received or paid upon settlement of the swap at the end of three years.

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

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

(b) The swap counterparty is senior to the debt and equity investors, and the debt and equity investors understand that they are also exposed to the credit risk from possible default by the swap counterparty to the extent the swap is an asset to the VIE.

(c) The interest rate swap is strongly indicated as a creator of variability because its underlying is based on observable market rates and it is senior in priority to other interest holders. Although the notional amount of the swap relates to a majority of the assets of the VIE, changes in the cash flows or fair value of the swap are not expected to offset all, or essentially all, of the risk or return (or both) related to those investments because the fair value and cash flows of the VIE’s investments are expected to be affected by risk factors other than changes in market interest rates (that is, credit risk).

(d) The VIE was not designed to create and pass along to its interest holders interest rate risk associated with changes in the fair value of
the fixed-rate periodic interest payments received on the fixed-rate investment portfolio and on the fixed leg of the swap, based on the nature and terms of the other contracts the VIE has entered into.

(e) The VIE was not designed to create and pass along to its interest holders interest rate risk associated with changes in the periodic interest payments received on the floating-rate investment portfolio, based on the nature and terms of the debt and equity interests issued by the VIE.

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

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

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

(a) Credit risk associated with a possible default by the issuers of the investments in the portfolio with respect to principal and interest payments

(b) Credit risk associated with a possible default by the cross-currency swap counterparty with respect to interest payments and the settlement amount, if any, due to the VIE at the end of five years

(c) Interest rate risk associated with changes in the fair value of the fixed-rate periodic interest payments received on the fixed-rate investment portfolio and on the receive leg of the cross-currency swap

(d) Foreign currency exchange risk associated with the periodic interest payments received on the fixed-rate JPY-denominated investments and the final receipt of principal at maturity

(e) Foreign currency exchange risk associated with the periodic interest payments or receipts and the amount received or paid upon final settlement of the cross-currency swap at the end of five years.

The following factors should be considered in the determination of the purpose(s) for which the VIE was created and in the determination of the variability the VIE is designed to create and pass along to its interest holders:
(a) The VIE was marketed to debt investors as a VIE that will be exposed to credit risk from possible default by the issuers of the JPY-denominated investments (principal and interest) as well as credit risk from possible default by the cross-currency swap counterparty, with the equity tranche negotiated to absorb the first dollar risk of loss related to these risks. It has been determined that substantive subordination is present with respect to these risks.

(b) The VIE was created to provide an investment vehicle for debt and equity investors to be exposed to the credit risk of entities whose securities are denominated in JPY.

(c) The swap counterparty is senior to the debt and equity investors, and the debt and equity investors are also exposed to the credit risk from possible default by the swap counterparty to the extent the swap is an asset to the VIE.

(d) The currency swap is strongly indicated as a creator of variability because its underlying is based on observable market rates and it is senior in priority to other interest holders. Although the notional amount of the swap relates to a majority of the assets of the VIE, changes in the cash flows or fair value of the swap are not expected to offset all, or essentially all, of the risk or return (or both) related to those investments because the fair value and cash flows of the VIE’s investments are expected to be affected by risk factors other than changes in foreign currency exchange rates (that is, credit risk).

The VIE was not designed to create and pass along to its interest holders interest rate risk associated with changes in the fair value of the fixed-rate periodic interest payments received on the fixed-rate investment portfolio and on the receive leg of the cross-currency swap, based on the nature and terms of the debt and equity contracts issued by the VIE.

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

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

55-68 A VIE is created and financed with $90 of 3-year floating-rate debt and $10 of equity from investors. The VIE uses the proceeds to purchase $100 of AAA-rated fixed-rate securities, which mature in 3 years. The fixed periodic interest payments received on the investments are used to pay the floating-rate interest to the debt holders with the remainder used to provide a return to the equity investor. At the end of three years, all the investments will mature with
Consolidation of Variable Interest Entities, Section 3

proceeds used, first, to pay the floating-rate debt holders and, second, to pay the equity holder to the extent proceeds remain. The VIE is not actively managed. The transaction was marketed to potential debt investors as an investment in a portfolio of high-quality fixed-rate investments with the equity tranche negotiated to provide support in the event of a credit default on the investments or in the event the fixed-rate return on the investments is not sufficient to pay the floating-rate coupon on the debt. The equity tranche was negotiated to absorb the first dollar risk of loss. The following diagram illustrates this situation.

55-69 The VIE is exposed to the following risks:
(a) Credit risk associated with a possible default by the issuers of the investments in the portfolio with respect to principal or interest payments
(b) Interest rate risk associated with changes in the fair value of the fixed-rate periodic interest payments received on the fixed-rate investment portfolio.

55-70 The following factors should be considered in the determination of the purpose(s) for which the VIE was created and in the determination of the variability the VIE is designed to create and pass along to its interest holders:
(a) The VIE was marketed to debt investors as an entity that will be exposed to changes in the fair value of periodic interest payments received on the investments due to changes in interest rates and credit risk associated with the investment portfolio, with the equity tranche negotiated to absorb the first dollar risk of loss. It has been determined that substantive subordination is present with respect to these risks.
(b) The equity investor has implicitly issued a $90 notional interest rate swap to the VIE in which that investor agrees to pay the VIE a floating rate and receive a fixed rate. However, the maximum amount payable to the VIE is limited to the equity investment. The debt
holders will absorb the remaining variability caused by changes in interest rates.

(c) The VIE was created to provide an investment vehicle for debt and equity investors to be exposed to the credit risk and interest rate risk associated with a mismatch between the assets (fixed-rate) and liabilities (floating-rate).

(d) The VIE was designed to create and pass along to its interest holders interest rate risk associated with changes in fair value of the periodic fixed-rate interest payments received on the investments, based on the nature and terms of debt and equity interests issued by the VIE.

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

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

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

55-72 The coupon on the floating-rate AAA-rated investments, plus the premium received on the credit default swap, will fund the coupon payment on the credit-linked notes. The VIE was marketed to potential investors as a floating-rate investment with an enhanced yield due to the assumption of credit risk of the referenced entity (in this case, ABC Entity). The following diagram illustrates this situation.
55-73 The VIE is exposed to the following risks:

(a) Credit risk associated with ABC Entity

(b) Credit risk associated with the AAA-rated investments

(c) Credit risk associated with possible default by Bank A with respect to premium payments made to the VIE

(d) Interest rate risk associated with changes in the cash flows from the interest payments received on the floating-rate investments.

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

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

(b) The VIE has sold credit protection on ABC Entity to Bank A and has purchased credit protection on ABC Entity from the note holders, who are expected to receive an enhanced return over the AAA floating rate investment for assuming the credit risk of ABC Entity and (to a lesser extent) the credit risk of Bank A.

(c) The written credit default swap is strongly indicated as a creator of variability because its underlying is based on observable market variables and it is senior in priority to other interest holders.

(d) The VIE was not designed to create and pass along to its interest holders interest rate risk associated with changes in cash flows from
the periodic interest payments received on the floating-rate investments, based on the nature and terms of the credit-linked notes issued by the VIE.

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

**Case F: Retail-Operating VIE**

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

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

(a) Sales volume risk

(b) Retail furniture price risk
(c) Inventory price risk
(d) Other operating cost risk.

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

(a) The VIE was created to enable the furniture manufacturer to extend its existing business line into a particular geographic region that lacked a viable distribution channel.

(b) The furniture manufacturer is absorbing variability from the operations of the VIE through its guarantee of the debt.

(c) The debt interest was negotiated as a fixed-rate investment in a retail operating VIE, supported by the furniture manufacturer.

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

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

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

(a) Price risk with respect to changes in fair value of the underlying property

(b) Credit risk associated with possible default by the lessee of the property with respect to the lease payments

(c) Interest rate risk associated with changes in the fair value of the future lease payments.

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

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

(b) The primary purpose for which the VIE was created was to provide the lessee with use of the property for five years with substantially all of the rights and obligations of ownership.

(c) The residual value guarantee effectively transfers substantially all of the risk associated with the underlying property (that is, declines in value) to the lessee. Therefore, the variability that is transferred to that interest holder is strongly indicated as variability that the VIE is designed to create and pass along to its interest holders.
(d) The fixed-price purchase option effectively transfers substantially all of the rewards from the underlying property (that is, increases in value) to the lessee.

(e) The VIE is designed to be exposed to the risks associated with a cumulative change in fair value of the leased property at the end of five years as well as credit risk from possible default by the lessee with regard to minimum lease payments.

(f) The VIE was marketed to potential investors as an investment in a portfolio of AA-rated assets collateralized by leased property that would provide a fixed-rate return to debt holders equivalent to AA-

(g) The role of the residual value guarantee and fixed-price purchase option in the design of the VIE, regardless of their legal form or accounting classification, dictates whether those interests shall be treated as creating risk for the VIE or absorbing risk from the VIE. Therefore, price risk with respect to changes in fair value of the underlying property is a relevant risk for the VIE, even though the lessor VIE records a direct financing lease receivable, rather than the property itself, on its balance sheet for accounting purposes.

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

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

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

(a) Electricity price risk, which affects the fair values of the fixed-price forward purchase contract and the fixed-price forward sales contract.

(b) Credit risk associated with possible default by the counterparty to the forward purchase contract.

(c) Credit risk associated with possible default by the counterparty to the forward sales contract.

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

(a) The VIE was designed to hold offsetting positions with respect to electricity price risk through a forward purchase contract and a forward sales contract with terms that are the same (except for fixed settlement price).

(b) The debt was marketed to the investors as a fixed-rate one-year investment with an enhanced yield due to risk of possible default by either Party A or Party B with respect to their forward contracts with the VIE.

(c) To the extent electricity prices rise and the forward purchase contract (with Party B) increases in value (from the VIE’s perspective), the debt investors will be exposed to credit risk to the extent that Party B defaults on its obligation.

(d) To the extent electricity prices drop and the forward sales contract increases in value (from the VIE’s perspective), the debt investors...
will be exposed to credit risk to the extent that Party A defaults on its obligation.

(e) The forward to buy electricity at a fixed price is strongly indicated as a creator of variability because its underlying is based on observable market prices and it is senior in priority to the debt holders.

(f) The forward to sell electricity at a fixed price is strongly indicated as a creator of variability because its underlying is based on observable market prices and is senior in priority to the debt holders.

Changes in fair value of each forward contract are expected to offset all, or essentially all, of the risk and return related to the other forward contract, so a further analysis of the design of the VIE is necessary in order to conclude whether each forward contract is a creator of variability or a variable interest.

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

(a) The debt interests in this VIE were marketed on behalf of the electricity producer as fixed-rate debt exposed to the credit risk of the counterparties to the forward agreements.

(b) The counterparties to the forward agreements did not participate significantly in the design of the VIE.

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

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

3.2.10. Overview

3.2.10.10. As stated in paragraph 3.1.10.10, variable interests have been broadly defined within ASC Subtopic 810-10. They may represent contractual, ownership, or other economic, monetary, or financial interests in an entity that change with changes in the fair value of the entity’s net assets (excluding the variable interests). Examples of potential variable interests include, but are not limited to:

- Equity and debt instruments;
- Beneficial interests;
- Guarantees;
- Put and call options;
- Forward contracts and other derivative instruments;
- Management and service contracts;
- Assets of an entity;
- Leases;
- Residual value guarantees;
- Franchise arrangements; and
- Co-manufacturing or marketing agreements.

3.2.20. Equity Investments, Debt Instruments, and Beneficial Interests

Excerpt from ASC Subtopic 810-10

Equity Investments, Beneficial Interests, and Debt Instruments

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

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

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

**EQUITY INVESTMENTS**

3.2.20.10. ASC paragraph 810-10-55-22 indicates that equity interests are variable interests to the extent they are at risk under the requirements of ASC subparagraph 810-10-15-14(a). Equity interests that are not at risk under this guidance may receive some of the expected residual returns, and even some of the expected losses, of a VIE. Whether equity interests that are not at risk under the guidance in ASC subparagraph 810-10-15-14(a) participate in a portion of the expected losses or expected residual returns of an entity, or both, depends on the facts and circumstances, including the reason that the equity is not considered at risk. We believe equity interests that are at risk under the guidance in ASC subparagraph 810-10-15-14(a) are variable interests under all circumstances.

**Question 3.2.20.1: Evaluating Whether Equity Is a Variable Interest in Trust Preferred Security and Similar Arrangements**

How should a sponsoring enterprise evaluate whether an equity interest that it holds in a trust preferred security structure or similar structure is a variable interest in the trust?

**Interpretive Response:** A trust-preferred securities arrangement generally involves the establishment by an enterprise, such as a bank, of a limited purpose trust (Trust) to issue the trust preferred securities. The Trust issues preferred securities to outside investors and uses the proceeds of the issuance to purchase from the enterprise an equivalent amount of junior subordinated debentures or other loans having stated maturities. The debentures or other loans are the only assets of the Trust. When the enterprise makes its payments of interest on the debentures or other loans, the Trust distributes the cash to the holders of the trust-preferred securities. The trust-preferred securities must be redeemed on maturity of the debentures or other loans. The
sponsoring enterprise typically holds all of the common equity of the Trust. The variability to be absorbed by the common equity interests is dependent on the sponsoring enterprise’s creditworthiness (i.e., its ability to repay the junior subordinated debentures or other loans), which essentially means that the Trust was designed to create and distribute the sponsoring enterprise’s credit risk to the sponsor. Accordingly, the common equity would not be considered equity at risk under ASC subparagraph 810-10-15-14(a) or a variable interest.

A typical trust preferred securities arrangement is structured as follows:

**Typical Trust Preferred Security Arrangement**

We believe that the analysis by the sponsoring enterprise of similar structures will not always be consistent with the common trust preferred security structure described above, as the conclusion will likely vary depending on the facts of the specific structure being evaluated. Based on informal discussions with the FASB staff, the sponsoring enterprise should evaluate whether the Trust was designed so that the sponsor’s interest represents an (1) obligation to or (2) an investment in the Trust. Additionally, the sponsoring enterprise should consider the risks that the entity was designed to create and distribute to its interest holders. In a typical trust preferred security arrangement, the Trust is designed to create and distribute the credit risk of the sponsoring enterprise. In this situation, the only asset of the Trust is a note receivable from the sponsoring enterprise (obligation to the Trust). However, if the Trust instead owns common stock of the sponsoring enterprise, it may be designed to create and distribute equity price risk, rather than credit risk, to the sponsoring enterprise. The sponsoring enterprise generally is not the sole source of equity price risk as it is for credit risk because equity price risk is dependent on numerous internal and external factors. The following examples further illustrate this concept:
In the example illustrated above, the sponsoring enterprise engages an investment bank to help the sponsor reduce the number of its outstanding common shares. The sponsoring enterprise will form a special-purpose entity (SPE) that will (1) issue debt to an investment bank and (2) purchase the common shares of the sponsoring enterprise in the open market with the funds received from the debt issuance. Generally, the interest payments on the debt are structured to match the dividends received by the SPE on the common shares. Additionally, the investment bank will also benefit by appreciation in the common shares of the sponsoring enterprise held by the SPE. In this fact pattern, we understand through informal discussions with the FASB staff that the sponsoring enterprise has a variable interest in the SPE through its common equity interests because the entity was designed to create and distribute equity price risk to the sponsor. In this instance, the sponsoring enterprise has no obligation to the SPE (e.g., note payable). Rather, the investment by the sponsoring enterprise in the SPE absorbs variability associated with the sponsoring enterprise’s common stock, which is driven by a myriad of internal and external economic factors.

Reverse Trust Preferred Security Arrangement

In the example illustrated above, the sponsoring enterprise transfers preferred stock (redeemable at the sponsor’s option) rather than a note receivable to the Trust in exchange for cash. Under ASC Subtopic 480-10, the sponsoring enterprise accounts for the preferred stock as debt. Furthermore, the investors in the Trust’s debt do not have recourse to the assets of the sponsoring enterprise in the event of default. It is our understanding based on informal
discussions with the FASB staff that, consistent with a common trust preferred
security structure, the equity held by the sponsoring enterprise would not be
considered a variable interest because it is not considered equity at risk. This
is because the preferred stock is the Trust’s only asset while it also represents
an obligation of the sponsoring enterprise to the Trust. That is, the Trust’s only
asset is also an obligation of the sponsoring enterprise.

DEBT INSTRUMENTS

3.2.20.20. We believe that, by their nature, an entity’s debt obligations (including
interest expense paid by the entity on such obligations) are always variable
interests. Although we believe that all debt instruments are variable interests, the
amount of variability associated with a given debt instrument depends on
whether it is a senior or subordinated interest. In general, the greater the level of
subordination, the greater the level of variability that will be absorbed or received
by the debt instrument. Senior debt instruments with fixed interest rates or other
fixed returns normally would absorb little variability. ASC paragraph 810-10-55-24
indicates that senior debt instruments with variable interest rates usually
should be evaluated in the same way as fixed-rate senior debt instruments. ASC
Subtopic 810-10 implies that this is because the variability of the debt instrument
resulting from fluctuations in interest rates generally does not represent
participation in the entity’s economic risks and rewards.

BENEFICIAL INTERESTS

3.2.20.30. Similar to debt instruments, we believe that, by their nature, an entity’s
beneficial interests other than derivatives (including interest expense paid by the
entity on such interests) are always variable interests. Further, we believe that
whether beneficial interests absorb expected losses of an entity should be
evaluated by first performing the same type of at risk analysis as that applied to
equity instruments under the requirements of ASC subparagraph 810-10-15-14(a). Under this approach, beneficial interests will usually absorb at least some
of an entity’s expected losses.

3.2.20.40. Although we believe all beneficial interests other than derivatives are
variable interests, the amount of variability associated with a given beneficial
interest depends on whether it is a senior or subordinated interest. In general, the
greater the level of subordination, the greater the level of variability that will be
absorbed or received by the beneficial interest. Senior beneficial interests with
fixed interest rates or other fixed returns normally would absorb little variability
and usually would not, by themselves, cause their holder to be the VIE’s primary
beneficiary. ASC paragraph 810-10-55-24 indicates that senior beneficial
interests with variable interest rates usually should be evaluated in the same way
as fixed-rate senior beneficial interests. ASC Subtopic 810-10 implies that this is
because the variability of the beneficial interest resulting from fluctuations in
interest rates does not represent participation in the entity’s economic risks and
rewards.
3.2.30. Guarantees, Written Put Options, and Similar Obligations

Excerpt from ASC Subtopic 810-10

Guarantees, Written Put Options, and Similar Obligations

55-25 Guarantees of the value of the assets or liabilities of a VIE, written put options on the assets of the VIE, or similar obligations such as some liquidity commitments or agreements (explicit or implicit) to replace impaired assets held by the VIE are variable interests if they protect holders of other interests from suffering losses. To the extent the counterparties of guarantees, written put options, or similar arrangements will be called on to perform in the event expected losses occur, those arrangements are variable interests, including fees or premiums to be paid to those counterparties. The size of the premium or fee required by the counterparty to such an arrangement is one indication of the amount of risk expected to be absorbed by that counterparty.

55-26 If the VIE is the writer of a guarantee, written put option, or similar arrangement, the items usually would create variability. Thus, those items usually will not be a variable interest of the VIE (but may be a variable interest in the counterparty).

3.2.30.10. Guarantees, written put options, and similar interests (which we believe includes insurance contracts) often protect a VIE’s senior variable interest holders from incurring economic losses. Even though a guarantee, written put option, or similar interest is not an investment, it is a variable interest in the entity if it must absorb variability of the entity or reduces another variable interest holder’s exposure to variability of the entity. Fees or premiums paid by the entity in connection with guarantees and similar interests, and written put options that are variable interests in the entity, are considered variable interests when computing expected losses and expected residual returns of the entity.

Question 3.2.30.1: Evaluation of Financial Guarantees as Potential Variable Interests

What factors should an enterprise consider when evaluating whether a financial guarantee arrangement represents a variable interest?

Interpretive Response: Enterprises (guarantors) that are party to a guarantee arrangement should first evaluate whether the guarantee relates to specified assets of another entity or to the other entity as a whole. If the guarantee relates to specified assets and those assets comprise more than half of the total fair value of the other entity’s total assets, the arrangement should be evaluated further. If the specified assets represent less than 50% of the fair value of the other entity’s total assets, the guarantee generally would not represent a variable interest in the entity as discussed further beginning at paragraph 3.4.10.10.
We believe that enterprises should understand the nature of the variability that the entity was designed to create and pass along to its variable interest holders. Financial guarantee arrangements are typically structured so that the guarantor absorbs credit-related variability associated with the entity to which the guarantee is provided or relates. As such, we believe that the guarantor generally would have a variable interest in the entity.

### 3.2.40. Forward Contracts and Purchase and Sale Contracts

<table>
<thead>
<tr>
<th>Excerpt from ASC Subtopic 810-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Forward Contracts</strong></td>
</tr>
<tr>
<td>55-27</td>
</tr>
<tr>
<td>55-28</td>
</tr>
</tbody>
</table>

### FORWARD CONTRACTS

**3.2.40.10.** Forward contracts may or may not be variable interests depending on the facts and circumstances. Consistent with the concept that contracts may create or absorb variability, ASC Subtopic 810-10 gives general guidance that the forward purchase or sale at fixed prices of assets not currently owned by the entity usually increases or creates variability in the entity. Those contracts are not variable interests. Conversely, forward sales at fixed prices of assets that are currently owned by the entity will usually absorb variability of the entity. Those contracts usually are variable interests if they are (a) for a strike price that may differ from the market price of the asset(s) upon settlement of the contract, and (b) deemed to represent an interest in the entity rather than an interest in specified assets under the guidance in ASC paragraphs 810-10-25-55 and 25-56.
3.2.40.20. ASC paragraphs 810-10-55-81 through 55-86 address an entity that has a forward contract with a third party to purchase an asset not owned by the entity and a separate forward contract with a third party to sell the asset to be acquired under the forward purchase contract. In that situation, the forward purchase contract and the forward sale contract are both viewed as creating or increasing variability in the entity (i.e., they are not viewed as variable interests). As a result, the forward sale contract is neither a variable interest in the entity nor an interest in specified assets of the entity.

3.2.40.30. Where a forward contract is a variable interest in an entity, we believe one acceptable method of determining the amount of variability absorbed by the counterparty to the forward contract is to calculate the variability of the VIE with and without the effect of the forward contract. The difference in total entity-level variability under the with and without calculations would be attributed entirely to the counterparty as its variable interest.

PURCHASE AND SALE CONTRACTS

3.2.40.40. Similar to forward contracts, an evaluation of the risks that the entity was designed to create and distribute should be performed to determine whether other purchase or sale contracts are variable interests. However, if a purchase or sale contract meets the definition of a derivative under ASC Topic 815, it should be evaluated under ASC paragraphs 810-10-25-35 and 25-36. If the contract is not a derivative, the first steps in the evaluation would be to determine whether the terms of the contract are at-market or contain any type of financial support embedded in the contract. Any type of off-market terms that provide financial support to an entity are typically a variable interest. Similar to other types of contracts deemed to be variable interests, a determination of whether the contract absorbs or creates variability should be made. The following table may be helpful when evaluating whether a purchase or sale contract is a creator or absorber of variability:

<table>
<thead>
<tr>
<th>Description</th>
<th>Pricing Terms Are Fixed</th>
<th>Pricing Terms Are &quot;At Market&quot;</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enterprise enters into a purchase contract with another entity</td>
<td>Contract generally would be considered by the enterprise as a variable interest because it absorbs the other entity’s variability</td>
<td>Contract generally would not be considered a variable interest because the terms are at fair value, resulting in no variability</td>
</tr>
<tr>
<td>Description</td>
<td>Pricing Terms Are Fixed</td>
<td>Pricing Terms Are &quot;At Market&quot;</td>
</tr>
<tr>
<td>-------------</td>
<td>------------------------</td>
<td>-----------------------------</td>
</tr>
<tr>
<td>Enterprise enters into a sale contract with another entity</td>
<td>Contract generally would be considered by the enterprise as a creator, rather than an absorber, of the other entity’s variability</td>
<td>Contract generally would not be considered a variable interest because the terms are at fair value, resulting in no variability</td>
</tr>
</tbody>
</table>

**Question 3.2.40.1: Real Estate Purchase and Sale Contracts**

Do real estate purchase and sale contracts represent variable interests?

**Interpretive Response:** An evaluation of the design of an entity holding real estate should be performed to determine whether a contract to sell real estate held by the entity (seller) is a variable interest in the entity (seller). A normal purchase and sale contract may not be a variable interest for many reasons, including the existence of certain conditions precedent to closing. Substantive conditions precedent to closing generally would support a conclusion that the purchase and sale contract does not create a variable interest in the seller of the real estate. We believe the factors that should be considered in evaluating whether there are substantive conditions precedent to closing include:

- Whether the existing lender is required to consent to the transfer of the property and the assumption of the existing loan and whether that consent has been received.
- Whether title requirements exist that the seller must comply with.
- Whether violations must be remedied before closing.
- Whether the seller must obtain estoppel certificates.
- Whether a material casualty to the property before closing would terminate the contract.
- Whether the seller or purchaser bears the risk of loss in the event of a material casualty.
- Whether any representations and warranties of the seller have been breached.

If the purchaser has a substantive right to terminate the contract prior to closing and receive a return of the escrow deposit, the contract could be considered a contingent forward contract that generally also would not be a variable interest. Conversely, if the contract does not provide the purchaser...
with a substantive right to terminate prior to closing, the contract likely would be a variable interest.

3.2.50. Other Derivative Contracts

Excerpt from ASC Subtopic 810-10

Other Derivative Contracts

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

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

3.2.50.10. Other derivative or compound instruments entered into with an entity may represent a variable interest to the counterparty if the instruments reduce the exposure of the entity to risks that cause variability in the entity and do not have the characteristics described in ASC paragraph 810-10-25-35 (i.e., market observable underlying and seniority in priority relative to other interest holders). Derivatives that expose the entity to risks that increase its expected variability are not variable interests.

Question 3.2.50.1: Total Return Swaps as Variable Interests

How should an enterprise evaluate whether a total return swap (or similar arrangement) represents a variable interest in a VIE?

Interpretive Response: Total return swaps are derivative instruments that allow an entity to transfer the risks and benefits related to a specific asset or group of assets to another entity without transferring those assets. We believe that understanding the design of the entity is important when determining whether a total return swap represents a variable interest in a VIE. As stated in ASC paragraphs 810-10-25-35 and 35-36, the total return swap may not represent a variable interest if the underlying is based on a market observable variable, the counterparty is senior in priority relative to other interest holders, and changes in the fair value or cash flows of the total return swap are not expected to offset all or substantially all of the risk and/or return related to a majority of the assets (excluding the total return swap) or operations of the entity. We believe enterprises should evaluate the following when analyzing whether a total return swap is a variable interest in an entity:
Whether the total return swap represents a variable interest in a silo as discussed in Section 5, Silos. While we do not believe that the presence of a total return swap necessarily creates a silo, it may represent a variable interest in a silo if the specific asset or asset group referenced by the total return swap is the only payment source for specified liabilities or other obligations. When applying the guidance in ASC paragraphs 810-10-25-35 and 35-36 to a silo, we believe that changes in the fair value or cash flows of the total return swap should be compared to the risk and/or return related to a majority of the silo’s assets. If the total return swap represents a variable interest, the specific asset or asset group is a silo, and the entity in which the silo resides is a VIE, then the total return swap counterparty should evaluate whether it is required to consolidate the silo.

To illustrate, assume SPE borrows money on a nonrecourse basis from Lender to fund the purchase of $800 of debt securities. SPE must pay interest of 3-month LIBOR plus 75 bps on the nonrecourse loan. SPE’s total assets have a fair value of $1,000. For risk management purposes, SPE enters into a total return swap with Bank whereby SPE receives 3-month LIBOR plus 75 bps while Bank receives the total return of the debt securities. Bank is senior in priority relative to other interest holders of SPE. Given this fact pattern, we believe that Bank has a variable interest in SPE’s silo (debt securities and nonrecourse debt) because (1) the returns of the debt securities are Bank’s sole source of payment and (2) the variability of the silo’s assets would be absorbed by Bank and Lender (i.e., change in the fair value of the debt securities would be absorbed entirely by the total return swap and nonrecourse loan).

Whether the total return swap represents a variable interest in the entity. Where the fair value of the specific asset or asset group to which the total return swap relates comprise a majority of the fair value of the entity’s assets, the enterprise should determine whether the total return swap represents a variable interest in the entity. If the underlying is not based on a market observable variable or the counterparty is not senior in priority relative to other interest holders, we believe that the total return swap generally would represent a variable interest. However, even if the underlying is based on a market observable variable and the counterparty is senior in priority relative to other interest holders, the total return swap may be considered a variable interest in the entity if changes in the fair value or cash flows of the total return swap are expected to offset all or substantially all of the risk and/or return related to a majority of the entity’s assets (excluding the total return swap) or operations.

To illustrate, assume SPE owns debt securities with a fair value of $750, all of which mature in five years. The debt securities bear
interest at 5% per year. SPE’s total assets have a fair value of $1,000, and none are held in a silo. For various business purposes, SPE enters into a total return swap with Bank whereby SPE receives 1-year LIBOR plus 75 bps while Bank receives the total return of the debt securities. Bank is senior in priority relative to other interest holders of SPE. Given this fact pattern, we believe that Bank has a variable interest in SPE because the assets underlying the total return swap comprise a majority of the fair value of SPE’s assets.

3.2.60. Assets of the Entity

Excerpt from ASC Subtopic 810-10

Assets of the Entity

55-32 Assets held by a VIE almost always create variability and, thus, are not variable interests. However, as discussed separately in this Subsection, assets of the VIE that take the form of derivatives, guarantees, or other similar contracts may be variable interests.

3.2.60.10. Assets of an entity almost always create rather than absorb or receive variability of the entity, and thus typically are not variable interests. However, assets that take the form of forward contracts, derivatives, guarantees, or similar contracts may be variable interests, as discussed earlier. In addition, assets of an entity that are not variable interests in the entity may have embedded features that are variable interests in the entity. As previously discussed, ASC Subtopic 810-10 provides that an embedded feature that is not clearly and closely related economically to its host should be evaluated separately to determine whether it is a variable interest. To determine whether an embedded feature is clearly and closely related economically to its host, a comparison of the nature of the underlying in the embedded derivative to the host instrument should be performed. If the value of an embedded derivative changes in a manner that is proportionate and highly correlated with changes in the value of the host instrument in response to the effects of changes in external factors, an embedded derivative would most likely be considered clearly and closely related economically to the host instrument. We understand that the FASB and SEC staffs have concluded that an embedded call option on a debt obligation is clearly and closely related economically to the debt host.

3.2.70. Operating Leases

Excerpt from ASC Subtopic 810-10

Operating Leases

55-39 Receivables under an operating lease are assets of the lessor entity and provide returns to the lessor entity with respect to the leased property during that portion of the asset’s life that is covered by the lease. Most operating
leases do not absorb variability in the fair value of a VIE’s net assets because they are a component of that variability. Guarantees of the residual values of leased assets (or similar arrangements related to leased assets) and options to acquire leased assets at the end of the lease terms at specified prices may be variable interests in the lessor entity if they meet the conditions described in paragraphs 810-10-25-55 through 25-56. Alternatively, such arrangements may be variable interests in portions of a VIE as described in paragraph 810-10-25-57. The guidance in paragraphs 810-10-55-23 through 55-24 related to debt instruments applies to creditors of lessor entities.

3.2.70.10. ASC Subtopic 810-10 indicates that most operating leases do not absorb variability and are therefore not considered variable interests in a VIE if the lease terms are consistent with market terms at the inception of the lease and do not contain residual value guarantees or fixed-price purchase options, or similar features.

3.2.70.20. The requirement in ASC paragraph 810-10-55-39 to determine whether an embedded feature such as a fixed-price purchase (call) option or residual value guarantee in a lease accounted for as an operating lease represents a variable interest in the lessor entity suggests that those embedded features are not clearly and closely related economically to the lease contract. That guidance appears to differ from the discussion in ASC paragraph 840-10-10-1, which indicates that residual value guarantees and purchase options are inextricably linked in conveying all or a portion of the economic risks and rewards of the leased asset from the lessor to the lessee. The guidance in ASC Topic 840, Leases, is consistent with our understanding of the negotiation process between lessors and lessees in commercial transactions. Therefore, we view the guidance in ASC paragraph 810-10-55-39 as an exception to the principle that an embedded feature that is clearly and closely related economically to its host contract should not be evaluated separately to determine whether it is a variable interest.

**Question 3.2.70.1: Evaluating Whether an Operating Lease Is a Variable Interest from the Lessee’s Perspective**

How should a lessee enterprise evaluate whether a plain vanilla operating lease with no residual value guarantees, fixed-price purchase options, or similar features is a variable interest in the lessor entity?

**Interpretive Response:** We believe that an operating lease is similar to a total return swap because the lessee makes fixed payments on a periodic basis and receives all returns from the operations of the leased asset. The guidance in ASC paragraph 810-10-55-39 has been interpreted to mean that an operating lease is not a variable interest in the lessor entity if the lease contains no purchase options at a price that could differ from the fair value of the property upon exercise of the option, no residual value guarantee, and no renewal options at rates that could differ from market rents upon exercise of the option (i.e., it is a plain vanilla operating lease). Where the lessor entity is a VIE and
the leased asset comprises a majority of the fair value of the lessor entity’s total assets, we view the guidance in ASC paragraph 810-10-55-39 as an exception to the guidance about variable interests generally and specifically in comparison to the guidance that applies to total return swaps. Operating leases other than plain vanilla operating leases should be carefully evaluated to determine whether their provisions result in the lessee absorbing variability of the lessor entity. For example, the following features may result in the lessee having a variable interest in the lessor as discussed in ASC paragraphs 810-10-55-78 to 55-80:

- **Purchase Options.** An option that provides the lessee with the right to purchase the leased asset at a fixed price or at a price derived by a formula may represent a variable interest because the lessee may have the ability to purchase the asset at a price other than its market value. However, if the purchase option relates to assets that comprise less than a majority of the fair value of the lessor entity’s assets, it generally would not be considered a variable interest.

- **Residual Value Guarantees.** Residual value guarantees are features embedded in leases that require the lessee to pay the lessor a specified amount if the leased asset is worth less than a predetermined amount at a future date. Because these features reduce the lessor’s risk of a decline in the leased asset’s value, they generally are considered to be a variable interest in the lessor entity if the leased asset comprises a majority of the fair value of the lessor entity’s assets.

- **Renewal Options or Term Extending Features.** Sometimes, leases may have embedded renewal options that allow the lessee to renew the terms of the lease at an amount other than market value upon exercise of the renewal option. Embedded term-extending features at rates that may differ from market rates upon exercise of the renewal option generally are not considered clearly and closely related economically to the lease host. Accordingly, these features generally would be variable interests if the leased asset comprises a majority of the fair value of the lessor entity’s assets.

**Question 3.2.70.2: Lease Prepayments to the Lessor Entity**

Do rent prepayments from the lessee to the lessor entity represent a variable interest in the lessor entity?

**Interpretive Response:** We believe that prepaid rent generally does not represent a variable interest in the lessor entity because it typically would not absorb the variability that the entity was designed to create and distribute to its interest holders.
Question 3.2.70.3: Evaluating Whether a Lease Is a Variable Interest from the Lessor’s Perspective

How should a lessor enterprise evaluate whether a lease is a variable interest in the lessee entity?

Interpretive Response: If the fair value of the leased asset does not exceed the total fair value of the lessee’s other assets, and other interests that the lessor holds in the lessee are insignificant or absorb little or none of the lessee’s variability, we believe the lease generally would not be considered a variable interest in the lessee to the lessor. In our view this is consistent with the analysis of nonrecourse lending arrangements, guarantees, and total return swaps. As discussed in ASC paragraphs 810-10-55-78 to 55-80, under a leasing arrangement, the lessor is exposed to the lessee’s credit risk (i.e., the lessee’s ability to pay under the terms of the lease). As a result, we believe that when the fair value of the leased asset is greater than the total fair value of the lessee’s other assets, or the lessor has other variable interests in the lessee that absorb more than an insignificant amount of the lessee’s variability, the lessor’s interest in a lease typically would represent a variable interest in the lessee.

3.2.80. Variable Interest of One VIE in Another VIE

Excerpt from ASC Subtopic 810-10

Variable Interest of One VIE in Another VIE

55-40 One VIE is the primary beneficiary of another VIE if it meets the conditions in paragraph 810-10-25-38A. A VIE that is the primary beneficiary of a second VIE will consolidate that second VIE. If another reporting entity consolidates the first VIE, that reporting entity’s consolidated financial statements include the second VIE because the second VIE had already been consolidated by the first. For example, if Entity A (a VIE) is the primary beneficiary of Entity B (a VIE), Entity A consolidates Entity B. If Entity C is the primary beneficiary of Entity A, Entity C consolidates Entity A, and Entity C’s consolidated financial statements include Entity B because Entity A has consolidated Entity B.

55-41 A transferor’s interests in financial assets in a VIE is a variable interest in the transferee entity but it is not a variable interest in a second VIE to which the transferee issues a beneficial interest. The following illustrates this point:

(a) Entity A transfers financial assets to VIE B (a VIE that holds no other assets), retains a subordinated beneficial interest, and reports the transfer as a sale under the provisions of Topic 860.

(b) VIE B issues all of its senior beneficial interests in the transferred assets to VIE C. VIE C issues various types of interests in return for
cash and uses the cash to pay VIE B. VIE B uses the cash received from VIE C to pay Entity A.

(c) Entity A’s subordinated beneficial interest is a variable interest in VIE B, but neither VIE B nor Entity A has a variable interest in VIE C.

3.2.80.10. ASC paragraph 810-10-55-41 indicates that a retained interest of a transferor of financial assets to a VIE generally is a variable interest in the transferee entity but is not a variable interest in a second VIE to which the transferee issues beneficial interests. We believe this guidance implies that an enterprise generally should not look through its involvement via a residual interest with a given VIE when one or more other VIE’s have involvement with the VIE unless there are implicit variable interests or related party considerations that require that approach. See Questions 3.3.30.5 through 3.3.30.7 for guidance on situations in which the enterprise has an implicit variable interest in an entity with which it has no direct involvement.

3.2.90. Netting or Offsetting Interests

Question 3.2.90.1: Netting of Interests When Applying the By Design Approach

Is it appropriate for interests to be netted when identifying variable interests?

Interpretive Response: We believe that it generally is not appropriate to net or offset positions when determining whether an enterprise holds a variable interest in another entity. Each arrangement with an entity should be separately evaluated to determine whether it is either a creator or absorber of variability. While the variability of certain interests that create variability may partially or fully offset each other, it would be inappropriate in most cases for contracts and arrangements that create variability to be netted with those that absorb variability and conclude that the entity was not designed to create and distribute a particular risk. For example, assume that a VIE purchased debt securities that were funded by the issuance of equity, subordinated debt and senior debt. It would be inappropriate in this scenario to offset the credit risk absorbed by the equity and subordinated debt interests against the variability created by the debt securities and conclude that the entity was designed to create and distribute credit risk to the senior debt interests.

However, there may be circumstances in which the design of an entity would lead an enterprise to conclude that certain interests should be netted. For example, assume that Entity A is funded with $500 received from Investor B in exchange for common equity and $500 from Investor C in exchange for senior debt. Entity A then uses the proceeds from the debt and equity issuances to purchase a $500 debt security issued by Investor B and $500 of equity securities from unaffiliated third parties. In this example, Investor B has two interests with Entity A, as Investor B owns $500 of equity in Entity A (absorber of variability) and also has $500 of obligations due to Entity A through the debt.
issuance (creator of variability). In this instance, it would be appropriate for
Investor B to exclude the risks of the $500 of debt that it owes to Entity A in
evaluating its exposure to variability of Entity A through its equity interest of
$500. We believe that all relevant facts and circumstances should be carefully
evaluated before reaching a conclusion in situations like these.

3.3. IMPLICIT VARIABLE INTERESTS

3.3.10. Overview

Excerpts from ASC Subtopic 810-10

Implicit Variable Interests

25-49 The following guidance addresses whether a reporting entity should
consider whether it holds an implicit variable interest in a VIE or potential VIE if
specific conditions exist.

25-50 The identification of variable interests (implicit and explicit) may affect
the following:

(a) The determination as to whether the potential VIE shall be
considered a VIE

(b) The calculation of expected losses and residual returns

(c) The determination as to which party, if any, is the primary beneficiary
of the VIE.

Thus, identifying whether a reporting entity holds a variable interest in a VIE or
potential VIE is necessary to apply the provisions of the guidance in the
Variable Interest Entities Subsections.

25-51 An implicit variable interest is an implied pecuniary interest in a VIE that
changes with changes in the fair value of the VIE’s net assets exclusive of
variable interests. Implicit variable interests may arise from transactions with
related parties, as well as from transactions with unrelated parties.

25-52 The identification of explicit variable interests involves determining which
contractual, ownership, or other pecuniary interests in a legal entity directly
absorb or receive the variability of the legal entity. An implicit variable interest
acts the same as an explicit variable interest except it involves the absorbing
and (or) receiving of variability indirectly from the legal entity, rather than
directly from the legal entity. Therefore, the identification of an implicit variable
interest involves determining whether a reporting entity may be indirectly
absorbing or receiving the variability of the legal entity. The determination of
whether an implicit variable interest exists is a matter of judgment that depends
on the relevant facts and circumstances. For example, an implicit variable
interest may exist if the reporting entity can be required to protect a variable
interest holder in a legal entity from absorbing losses incurred by the legal entity.

25-53 The significance of a reporting entity’s involvement or interest shall not be considered in determining whether the reporting entity holds an implicit variable interest in the legal entity. There are transactions in which a reporting entity has an interest in, or other involvement with, a VIE or potential VIE that is not considered a variable interest, and the reporting entity’s related party holds a variable interest in the same VIE or potential VIE. A reporting entity’s interest in, or other pecuniary involvement with, a VIE may take many different forms such as a lessee under a leasing arrangement or a party to a supply contract, service contract, or derivative contract.

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

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

3.3.10.10. Implicit variable interests commonly arise in leasing arrangements among related parties, and in other types of arrangements involving related parties and unrelated parties. All reporting enterprises, including public entities¹, are required to determine whether they hold an implicit variable interest in a VIE or potential VIE, as illustrated in the example below. This example was included in ASC Topic 810 before amendment by FASB Accounting Standards Update 2014-07 (ASU 2014-07), Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements, to provide a practical expedient for private companies. Although the example was eliminated by ASU 2014-07, we believe it remains relevant for reporting enterprises that do not qualify for the practical expedient in ASC paragraph 810-10-15-17A.

¹ See Subsection 2.4 for a practical expedient to the VIE consolidation guidance for common control leasing arrangements for private companies.
**Example 3.3.10.1: Implicit Variable Interests**

The controlling shareholder of Manufacturing Entity, a public business entity, is also the sole owner of Leasing Entity, a VIE. The owner of Leasing Entity provides a guarantee of Leasing Entity’s debt as required by the lender. Leasing Entity owns no assets other than the manufacturing facility being leased to Manufacturing Entity. The lease, with market terms, contains no explicit guarantees of the residual value of the real estate or purchase options and is therefore not considered a variable interest under ASC paragraph 810-10-55-39. The lease meets the classification requirements for an operating lease and is the only contractual relationship between Manufacturing Entity and Leasing Entity.

Manufacturing Entity should consider whether it holds an implicit variable interest in Leasing Entity. Although the lease agreement itself does not contain a contractual guarantee, Manufacturing Entity should consider whether it holds an implicit variable interest in Leasing Entity as a result of the leasing arrangement and the relationship between it and the owner of Leasing Entity. For example, Manufacturing Entity would be considered to hold an implicit variable interest in Leasing Entity if Manufacturing Entity effectively guaranteed the owner’s investment in Leasing Entity. The guidance in ASC paragraphs 810-10-25-49 through 25-54 should be used only to evaluate whether a variable interest exists under the Variable Interest Entities Subsections and should not be used in the evaluation of lease classification in accordance with ASC Topic 840, *Leases*. ASC paragraph 840-10-25-26 addresses leases between related parties.

Manufacturing Entity may be expected to make funds available to Leasing Entity to prevent the owner’s guarantee of Leasing Entity’s debt from being called on, or Manufacturing Entity may be expected to make funds available to the owner to fund all or a portion of the call on Leasing Entity’s debt guarantee. The determination as to whether Manufacturing Entity is effectively guaranteeing all or a portion of the owner’s investment or would be expected to make funds available and, therefore, an implicit variable interest exists, should consider all the relevant facts and circumstances. Those facts and circumstances include, but are not limited to, whether there is an economic incentive for Manufacturing Entity to act as a guarantor or to make funds available, whether such actions have happened in similar situations in the past, and whether Manufacturing Entity acting as a guarantor or making funds available would be considered a conflict of interest or illegal.

**3.3.10.20.** When identifying potential variable interests, enterprises should consider whether implied variable interests are present, in addition to those formed by explicit contractual or legal agreements. The identification of potential implicit variable interests is important because they affect both the determination of whether an entity is a VIE (e.g., because they protect the holders of the entity’s equity at risk) and the determination of a VIE’s primary beneficiary. An implicit
variable interest is an interest that participates in the economic risks and (or) rewards of another entity, just as an explicit variable interest does; however, implicit and explicit variable interests differ with respect to how variability is absorbed (i.e., indirectly versus directly). The potential for the existence of implicit variable interests was implicitly referenced by a member of the SEC staff (Jane Poulin) in a speech at the 2004 AICPA National Conference on Current SEC and PCAOB Developments. An excerpt from the speech follows:

Excerpt from Speech by Jane D. Poulin

We have seen a number of questions about whether certain aspects of a relationship that a variable interest holder has with a variable interest entity (VIE) need to be considered when analyzing the application of [the VIE guidance in ASC Subtopic 810-10]. These aspects of a relationship are sometimes referred to as activities around the entity. It might be helpful to consider a simple example. Say a company (Investor A) made an equity investment in a potential VIE and Investor A separately made a loan with full recourse to another variable interest holder (Investor B). We have been asked whether the loan in this situation can be ignored when analyzing the application of [the VIE guidance in ASC Subtopic 810-10]. The short answer is no. First, [the VIE guidance in ASC Subtopic 810-10] specifically requires you to consider loans between investors as well as those between the entity and the enterprise in determining whether equity investments are at risk, and whether the at risk holders possess the characteristics of a controlling financial interest as defined in [ASC paragraph 810-10-15-14(b)]. It is often difficult to determine the substance of a lending relationship and its impact on a VIE analysis on its face. You need to evaluate the substance of the facts and circumstances. The presence of a loan between investors will bring into question, in this example, whether Investor B’s investment is at risk and depending on B’s ownership percentage and voting rights, will influence whether the at risk equity holders possess the characteristics of a controlling financial interest.

Other activities around the entity that should be considered when applying [the VIE guidance in ASC Subtopic 810-10] include equity investments between investors, puts and calls between the enterprise and other investors and non-investors, service arrangements with investors and non-investors, and derivatives such as total return swaps. There may be other activities around the entity that need to be considered, which I have not specifically mentioned. These activities can impact the entire analysis under [the VIE guidance in ASC Subtopic 810-10] including the assessment of whether an entity is a VIE as well as who is the primary beneficiary.

In another situation involving activities around the entity, investors became involved with an entity because of the availability of tax credits generated from the entity’s business. Through an arrangement around the entity, the majority of the tax credits were likely to be available to one specific investor. Accordingly, the staff objected to an analysis by this investor that 1) did not include the tax credits as a component of the investor’s variable interest in the
entity and 2) did not consider the impact of the tax credits and other activities around the entity on the expected loss and expected residual return analysis.

\[ \text{FIN 46R, paragraph 5(a)(4) [ASC paragraph 810-10-15-14(a)(4)].} \]

\[ \text{FIN 46R, paragraph 5(b) [ASC paragraph 810-10-15-14(b)].} \]

3.3.10.30. Implicit variable interests can arise from contractual or noncontractual arrangements in transactions involving related or unrelated parties. While a thorough evaluation of all relevant facts and circumstances is important when identifying potential implicit variable interests, enterprises should assess the terms of any transactions with an entity in which the enterprise either has an explicit variable interest or a related party of the enterprise has a variable interest.

3.3.20. Contractual Implicit Variable Interests

3.3.20.10. The evaluation of whether a contractual arrangement is an implicit variable interest should include consideration of whether the assets of the VIE are unique and whether the contract was entered into contemporaneously with or in contemplation of the VIE’s formation (see additional discussion in Paragraph 3.3.20.30.). The consideration of whether the net assets (and related economic risks and rewards) of the VIE are unique is relevant because economic risks and rewards of the VIE’s net assets that are not present in the marketplace outside of the VIE are inherently specific to the VIE and thus a contract that participates in some or all of those economic risks and (or) rewards is, by definition, a variable interest in the VIE. That is, if specific economic risks or rewards only exist within a VIE, then interests that participate in those economic risks and (or) rewards are variable interests in the VIE even if the VIE is not a counterparty to the contract that conveys the participation in that variability. Conversely, participation in economic risks and (or) rewards that exist outside of a VIE through a contract with a counterparty other than the VIE would not necessarily point to participation in the VIE’s variability even if those same (or similar) economic risks and rewards exist within the VIE. (Note that participation in a VIE’s economic risks and (or) rewards through a contract with the VIE is a variable interest in the VIE even if the net assets of the VIE are not unique.)

3.3.20.20. Determining whether net assets of a VIE are unique requires judgment based on all relevant facts and circumstances. In making that determination, we believe these factors should be considered:

- The number of investors and the related market liquidity of a particular asset may indicate whether an asset is considered unique.
- Assets available in liquid markets generally are not unique (e.g., treasuries, exchange-traded equity securities, public debt, rated debt, agency mortgage-backed securities, etc.).
• Assets not specifically available in a liquid market may be unique (e.g., specific trade or loan receivables, physical assets, certain over-the-counter or thinly-traded equity instruments, lease receivables, etc.).

• Assets that are not unique may be held in an aggregate fashion that creates an economic risk and (or) reward profile that is unique. For example, a trust that holds only marketable securities may hold those securities in an aggregate manner that presents an economic risk and (or) reward profile that is unique. A reporting enterprise with an exposure to the economic risks and (or) rewards of such a trust may have an implicit variable interest in the trust.

• Other asset classes may require more judgment (e.g., collateralized loan obligations (CLOs), collateralized debt obligations (CDOs), etc.). For example:
  • *Commercial loans held by a CLO:* Commercial loans held by a CLO that is a VIE may be considered unique.
  • *Securities issued by a CLO:* If a VIE invests, along with multiple other parties, in a portion of one tranche of rated investment securities issued by a CLO, the VIE’s assets typically would not be unique. (Note that the VIE holding the investment securities issued by the CLO has a variable interest in the CLO.)
  • *Debt securities held by a CDO:* Highly liquid debt securities held by a CDO that is a VIE would typically not be considered unique.

3.3.20.30. Even if the net assets of a VIE are not unique, a contract entered into between one or more of a VIE’s variable interest holders and another party contemporaneously with or in contemplation of the formation of the VIE and the issuance of other variable interests in the VIE to lay off some or all of their exposure to the VIE’s economic risks and rewards may be an implicit variable interest in the VIE.

3.3.20.40. When a transaction is structured in a manner that, contemporaneously with or in contemplation of the formation of a VIE, involves one or more of the VIE’s variable interest holders laying off some or all of their exposure to the VIE’s economic risks and rewards to a party that does not have a contractual relationship directly with the VIE, the contract between those variable interest holders and the third party is an aspect of the VIE’s design and should be considered in identifying variable interests in the VIE under the guidance in ASC paragraph 810-10-55-19. That evaluation should include consideration of whether the risks transferred through the arrangement represent all or a portion of the specific risks of the explicit variable interest.

3.3.30. Noncontractual Implicit Variable Interests

3.3.30.10. It is our understanding that one of the principal reasons for the guidance on implicit variable interests was the concern that a lessee that protects a related party VIE lessor from losses on the leased property, even though it has
no contractual obligation to do so, should not be able to inappropriately avoid consolidation of the lessor.\textsuperscript{2} Variable interest holders of a VIE lessor may have the ability to significantly influence the lessee’s actions so as to protect the lessor (or themselves) from some or all of the economic risks of the leased property. Such influence could exist for example because (a) the lessee and lessor are under common control, (b) the lessor is owned by a party with the ability to exercise significant influence over the lessee (e.g., through ownership of a significant share of the lessee’s voting stock), or (c) the lessor is owned by a party with a significant role in the lessee’s operations (e.g., a member of the lessee’s senior management such as the CEO or a member of the lessee’s board of directors). See Subsection 2.4 for a discussion of a practical expedient to the VIE consolidation guidance for common control leasing arrangements for private companies.

\textbf{3.3.30.20.} We expect that noncontractual implicit variable interests most typically will arise in arrangements that involve related parties, such as leasing arrangements that involve related parties. However, noncontractual implicit variable interests also may arise in arrangements that involve unrelated parties and, accordingly, all relevant facts and circumstances should be considered when evaluating whether a reporting enterprise has a noncontractual implicit variable interest in an entity. Some of the factors to consider in determining whether an implicit variable interest exists in addition to those discussed in ASC paragraph 810-10-55-89 include, but are not limited to:

\begin{itemize}
  \item \textit{Nature of the relationship with other variable interest holders, including whether another variable interest holder has the ability to control the reporting enterprise.} For example, if the CEO of an enterprise is also the owner of a controlling financial interest in the only supplier of a product or service to the enterprise, this may indicate that the enterprise has implicitly guaranteed that the entity will not incur losses from the supply arrangement.
  \item \textit{Nature of the economics between the reporting enterprise and other variable interest holders.} For example, if a parent entity owns a 100% financial interest in the reporting enterprise and a related party entity, there would be no economic benefit to the parent from causing the enterprise to provide support to the related party entity. However, if the reporting enterprise was not wholly owned while the related party was wholly owned by the reporting enterprise’s parent, there may be an economic incentive for the parent to cause the reporting enterprise to provide support to the related party entity.
  \item \textit{Restrictions or regulations under which the reporting enterprise operates.} For example, it may be necessary for a reporting enterprise to provide financial support to another variable interest holder (e.g., a
\end{itemize}

\textsuperscript{2} Such protection may also be provided implicitly by a lessee to one or more investors (variable interest holders) in a VIE lessor. Such protection is not limited to a reimbursement of the lessee for losses incurred, but may also be provided, for example, through a decision to renew the lease at an above-market rate of rent.
related party) to prevent or cure a punitive regulatory action. Conversely, the reporting enterprise may be subject to laws and regulations that make it a conflict of interest or illegal to provide support to another party that the reporting enterprise is not contractually obligated to provide. Governance provisions or other controls that apply to the reporting enterprise also may preclude it from providing support to a related party. For example, a lessee that leases property from a related party lessor may be unable to provide support to the lessor that it is not contractually obligated to provide if the lessee has an independent board or committee of the board that is required to review related party leasing transactions and can approve them only if they are determined to be on market terms.

- **Whether other parties that are involved with the reporting enterprise or related party believe that an implicit variable interest exists.** For example, the interest offered on debt issued by a special-purpose entity may be lower when there is a reasonable expectation in the market that a sponsoring reporting enterprise would provide financial support to the special-purpose entity in the event of default.

- **Whether the reporting enterprise has provided support that it was not obligated to provide to related parties in the past.** When a reporting enterprise has previously provided support to an entity that it was not obligated to provide, this may indicate that the reporting enterprise will do so again either for that entity or for similar entities with which it is involved. In some cases, a reporting enterprise’s history of providing support that it was not obligated to provide may establish a reasonable expectation in the market that the reporting enterprise would provide support in the future thereby increasing the likelihood that the reporting enterprise will do so.

### 3.3.30.30

An enterprise also may enter into arrangements with variable interest holders in an effort to shield those holders from absorbing significant amounts of the entity’s variability. These situations may create implicit variable interests in the entity. In determining whether the reporting enterprise has an implicit variable interest in these scenarios, the enterprise should consider all relevant facts and circumstances, including but not limited to:

- The timing of when the contract was entered into (e.g., at formation or concurrently with the issuance of the variable interest);
- Parties with whom the contract was entered into (e.g., with the variable interest holders rather than the entity);
- Whether any specified assets of the entity were referenced or noted in the contract (e.g., a guarantee of the value of specified assets of an entity that is provided to a third party rather than to the entity); and
- The substance of the arrangement.
Question 3.3.30.1: Considerations for Determining Whether an Implicit Variable Interest Exists

What are some considerations in determining whether a reporting enterprise has an implicit variable interest in an entity?

Interpretive Response: This question was addressed by a member of the SEC staff in a speech at the 2005 AICPA National Conference on Current SEC and PCAOB Developments. An excerpt from the speech follows.

Excerpt from Speech by Mark Northan

At this conference last year, Jane Poulin briefly mentioned the need to consider activities around the entity when applying [the VIE requirements of ASC Subtopic 810-10] and that certain types of activities could impact both the determination of whether an entity is a variable interest entity as well as identification of the primary beneficiary.⁷

The FASB staff addressed some of these issues earlier this year when they issued a staff position on implicit variable interests.⁸ This FSP provides guidance for determining when activities around the entity would cause a reporting enterprise to have a variable interest. The FSP describes an implicit variable interest as an interest that absorbs or receives the variability of an entity indirectly rather than through contractual interests in the entity.⁹ The guidance does not however provide a bright-line for determining when an implicit variable interest exists. Instead, the FSP indicates that such determinations are a matter of judgment and will depend on the relevant facts and circumstances.¹⁰

At the end of the FSP, the FASB staff provides one comprehensive example of the how the FSP should be applied. In that example a company leases an asset from an entity that is entirely owned by a related party. Under the FSP, the lessee company would hold an implicit interest in the lessor company if it effectively guaranteed the related party’s investment.

The guidance on implicit variable interests is important for a number of reasons. In particular, it helps meet the objective in [the VIE requirements of ASC Subtopic 810-10] that variable interest entities should be consolidated by a company that has a majority of the risks and rewards.¹¹ It also prevents registrants from circumventing the [VIE requirements of ASC Subtopic 810-10] by absorbing variability indirectly such as through an arrangement with another interest holder rather than directly from the entity.

With these thoughts in mind, I would like to highlight a few things about implicit variable interests. First, while much of the discussion in the FSP focuses on the example of a noncontractual interest in a leasing transaction between related parties, it is important to note that implicit interests can also result from contractual arrangements with unrelated variable interest holders. For instance, we recently evaluated a registrant’s conclusion that it was not
the primary beneficiary of a variable interest entity because it did not have any interest in the entity whatsoever. However, following several inquiries from the staff it became clear that the registrant had entered into contractual agreements with several of the variable interest holders that effectively protected those holders from absorbing a significant amount of the entity’s variability. In this circumstance, we concluded that the contractual agreements with the variable interest holders were implicit interests in the variable interest entity. The registrant was, in fact, absorbing a majority of the expected losses through those implicit interests and was therefore the primary beneficiary despite having no direct contractual interest in the variable interest entity.

Consistent with the FASB staff’s guidance, we believe that identification of implicit variable interests is a matter of judgment that depends on individual facts and circumstances. Again, there are no "bright-line" tests that can be applied to easily identify these arrangements. However, with this in mind, registrants should consider the following questions in evaluating whether or not a contractual arrangement with a variable interest holder is an interest in the entity:

- Was the arrangement entered into in contemplation of the entity’s formation?
- Was the arrangement entered into contemporaneously with the issuance of a variable interest?
- Why was the arrangement entered into with a variable interest holder instead of with the entity?
- And lastly, did the arrangement reference specified assets of the variable interest entity?

While answers to these questions might not provide definitive conclusions for every circumstance, we believe that they will provide a good starting point for evaluating whether an implicit variable interest exists.

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7 See remarks by Jane Poulin at the 2004 AICPA National Conference on SEC and PCAOB Developments
8 FSP No. FIN 46(R)-5, Implicit Variable Interests under FASB Interpretation No. 46(R) [now included in ASC Subtopic 810-10]
9 Refer to paragraph 4 of FSP No. FIN 46(R)-5 [ASC paragraph 810-10-25-52].
10 Refer to paragraph 4 of FSP No. FIN 46(R)-5 [ASC paragraph 810-10-25-52].
11 Refer to paragraph E7 of FIN 46(R) [ASC paragraph 810-10-05-10] which states that "Risks, benefits, or both are the determinants of consolidation in [the Variable Interest Entities Subsections]."
**Question 3.3.30.2: Effect of an Implicit Variable Interest on Variability Absorbed by Explicit Variable Interests**

How does the existence of an implicit variable interest affect the variability absorbed by an entity’s explicit variable interests?

**Interpretive Response:** A VIE’s variable interests collectively absorb all of the economic risks and rewards that the VIE is designed to create and pass along to its variable interest holders. Accordingly, when a VIE has implicit and explicit variable interests, a portion of the variability absorbed according to the terms of the explicit variable interests shifts to the implicit variable interests (i.e., the variability absorbed by the implicit variable interests reduces the variability absorbed by the explicit variable interests). The reduction in variability absorbed by each variable interest holder due to the reallocation of variability to implicit variable interests may be limited due to the credit risk associated with performance by the implicit variable interest holder in absorbing the variability allocable to its implicit variable interest. As a result, the variability allocated to implicit variable interests may exceed the reduction in variability allocable to the other variable interests. In certain circumstances implicit variable interests may absorb a portion of the variability of other implicit variable interests. This could occur, for example, when Guarantor A, which has an implicit variable interest in a VIE whose net assets are unique, obtains a guarantee from Guarantor B for a portion of the risk with respect to the VIE that is absorbed by Guarantor A. In that situation, both Guarantor A and Guarantor B may have implicit variable interests in the VIE, and Guarantor B’s implicit variable interest may reduce the variability allocable to Guarantor A’s implicit variable interest.

**Question 3.3.30.3: Implicit Variable Interests and Support Provided by Sponsors of Certain Investment Entities**

Does a sponsor of an investment vehicle have an implicit variable interest in an entity to which it provides support that it is not obligated to provide and/or in entities to which it does not provide such support?

**Background:** During an economic downturn, investment entities may experience losses for a variety of reasons (e.g., as a result of turmoil in the credit markets), with such losses leading to subsequent rating agency downgrades of securities issued by those investment entities. In some instances, the realized or unrealized losses associated with those securities may raise the possibility that investors holding the securities might be adversely affected by a temporary decline in their value even if the investor does not intend to sell the securities. To limit the downward fluctuations in value of investment securities issued by investment entities under their management, sponsors of investment entities may provide support to the
entities that the sponsor is not contractually required to provide. This support is
designed to limit or reduce the economic losses of the investors.

For purposes of this guidance the term investment entity is intended to broadly
apply to any structure or account used to provide a method for external parties
to invest, whether or not the vehicle is a separate legal entity. Entities that are
considered to be investment entities for purposes of this guidance include, but
are not limited to:

- Structured Investment Vehicles (SIVs);
- Mutual Funds;
- Collateralized Debt Obligation (CDO) entities;
- Collateralized Loan Obligation (CLO) entities;
- Hedge Funds;
- Separate Accounts;
- Bank Common and Collective Trust Funds; and
- Commercial Paper (CP) Conduits

Common types of financial support provided by sponsors/advisors include, but
are not limited to:

- Capital contributions;
- Agreements to purchase assets at an amount above fair value (e.g.,
at par value when the fair value is less than par);
- Purchasing interests issued by the investment vehicle for the
  sponsor’s own account (creating liquidity in the interests issued by
  the investment vehicle and potentially supporting the price of those
  interests);
- Guarantees of principal and interest;
- Guarantees of a specific financial instrument held by an investment
  vehicle (including partial guarantees);
- Providing or replacing a liquidity support agreement;
- Standby letters of credit; and
- Assertions that support may be provided.

In periods of economic distress, these types of activities have occurred in a
wide variety of investment vehicles. Often the support provided is limited to an
individual investment held by the entity or is capped at a specific dollar limit
and the support can be relatively small in relation to the overall size of the
entity’s assets or liabilities.

If an investment entity does not qualify for the consolidation scope exception
that applies to registered money market funds and similar entities (see
Subsection 2.2), the sponsor must consider whether the investment entity is a
VIE that must be evaluated for consolidation under the VIE consolidation provisions of ASC Subtopic 810-10. As indicated in ASC paragraph 810-10-25-50, the identification of implicit variable interests affects the determination of whether an entity is a VIE, the calculation of expected losses and expected residual returns, and the determination of which party, if any, is the primary beneficiary of the entity if it is a VIE. Consequently, determining whether a reporting enterprise has an implicit variable interest in an entity is necessary to apply the VIE provisions of ASC Subtopic 810-10.

Interpretive Response: ASC paragraph 810-10-25-52 states that “the identification of an implicit variable interest involves determining whether a reporting entity may be indirectly absorbing or receiving the variability of the legal entity. The determination of whether an implicit variable interest exists is a matter of judgment that depends on the relevant facts and circumstances. For example, an implicit variable interest may exist if the reporting entity can be required to protect a variable interest holder in a legal entity from absorbing losses incurred by the legal entity.” ASC paragraph 810-10-55-89 discusses factors to consider in determining whether an implicit variable interest exists. Those factors include, but are not limited to, whether there is an economic incentive for a sponsor of an investment entity to act as a guarantor or to make funds available, whether such actions have happened in similar situations in the past, and whether the sponsor acting as a guarantor or making funds available would be considered a conflict of interest or illegal.

When a sponsor provides support to an investment entity that the sponsor is not obligated to provide, we believe the sponsor obtains a new explicit variable interest in that investment entity (i.e., the support provided) if the support is ongoing (e.g., standby letters of credit). In general, we believe that the sponsor also obtains a new implicit variable interest to provide support to that investment entity and any other investment entities that it sponsors in which investors would have a reasonable expectation that the sponsor would provide support due to the similarity of those investment entities to the entity to which the sponsor provided support (regardless of whether the support actually provided is ongoing or not). Consistent with the guidance in ASC paragraph 810-10-55-89 that new implicit variable interest arises because the sponsor has an economic incentive to provide support, it has now done so in similar situations in the past, and taking such action is not considered to be a conflict of interest or illegal. We do not believe that the implicit variable interest would be limited to specified assets of the investment entity if a sponsor is unwilling or unable to assert that it would not provide support for losses arising from other assets of the entity if such losses occurred. We believe the nature of the variability absorbed by the implicit variable interest typically depends on the nature of the support actually provided by the sponsor and the risks that investors in the investment entity would have absorbed in the absence of the support provided by the sponsor.
Question 3.3.30.4: Fee Waivers in Investment Management Arrangements

Does the waiver by an investment manager of its fee from a mutual fund for a period of time cause the investment manager to have an implicit variable interest in the fund?

**Background:** Investment managers of mutual funds generally earn a fee that is based on a percentage of the fair value of the assets under management. During recent years, some mutual fund managers chose to provide financial support to their managed funds (particularly money market funds), including capital contributions, standby letters of credit, guarantees of principal and interest, and agreements to purchase troubled securities at amortized cost or par. In addition, some managers chose to waive all or a portion of their management fee for a period of time. The evaluation of whether the waived management fee represents an implicit variable interest in the fund is significant because these investment managers often lack explicit variable interests in the mutual fund other than the potential variable interest associated with their management fees.

**Interpretive Response:** No. The FASB staff has indicated in informal discussions that they do not believe the waiver of a management fee by an investment manager for a period of time would cause the investment manager to have an implicit variable interest in the fund. We believe this is consistent with the guidance in ASC paragraphs 810-10-25-48 to 25-54, 55-88, and 55-89. The waiver of the management fee for a limited period of time can be viewed as a reduction in compensation to the manager for substandard performance rather than an interest that absorbs the risks that, by design, are intended to be created and passed through to the fund’s variable interest holders. Therefore, it does not, in and of itself, cause the investment manager to have an implicit variable interest in the fund.

Question 3.3.30.5: Implicit Variable Interest through a Total Return Swap

Assume that Investor A purchases common stock representing a variable interest in CKW, Inc. (CKW) under ASC Subtopic 810-10. Investor A then enters into a total return swap (TRS) with Investor B, an unrelated third party, with the following terms and provisions:

- Investor A pays all returns it receives from its ownership of CKW’s common stock (e.g., dividends, capital appreciation, etc.) to Investor B on specified dates, including upon maturity of the TRS; and
- Investor B pays Investor A any declines in the fair value of CKW’s common stock and fixed payments on specified dates, including upon maturity of the TRS.
Does Investor B have a variable interest in CKW because of its role in the total return swap arrangement described above?

**Interpretive Response:** While Investor B does not have a direct variable interest in CKW, it is required to determine whether its role in the total return swap arrangement represents an implicit variable interest. Specifically, the arrangement should be evaluated to understand whether it results in Investor B protecting Investor A by absorbing variability in CKW. Although Investor B does not own direct shares in CKW, the total return swap is structured to transfer the variability (risks and benefits) from Investor A to Investor B. Accordingly, we believe that the total return swap represents a variable interest for Investor B in CKW. This analysis is consistent with the guidance in ASC paragraph 810-10-25-31, which discusses interests that transfer all or a portion of the risk or return (or both) of certain assets or operations of an entity. In particular, it states that a transfer of variability (e.g., through a total return swap) strongly indicates the entity was designed to create and pass along this variability to its interest holders. We believe that Investor B also would conclude that it had a variable interest in CKW had it entered into the swap arrangement directly with CKW.

**Question 3.3.30.6: Implicit Variable Interest through a Call or Put Option**

Assume Investor A holds common stock that represents a variable interest in BW, Inc. (BW). Investor A then writes a call option to Investor B (an unrelated third party) that allows Investor B to purchase the common stock of BW that Investor A holds at a predetermined price. Additionally, Investor A purchases a put option from Broker (an unrelated third party) that allows Investor A to sell the common stock of BW that it holds to Broker at a predetermined price.

Does Investor B have a variable interest in BW because it possesses a call option in Investor A’s common shares of BW? Similarly, does Broker possess a variable interest in BW because of the put option between Broker and Investor A?

**Interpretive Response:** Yes. While Investor B and Broker do not have explicit variable interests in BW, the call and put options cause them to hold implicit variable interests in BW because they absorb variability of BW.

**Question 3.3.30.7: Implicit Variable Interest through an Asset Guarantee Arrangement**

Assume Investor A guarantees the value of the assets owned by Entity X. Based on an evaluation of the guidance in ASC Subtopic 810-10, Investor A concludes that the guarantee represents a variable interest in Entity X. Investor A also enters into an arrangement with Insurer, an unrelated third party that
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requires Insurer to pay Investor A for any decline in the value of Entity X’s assets.

Does Insurer have a variable interest in Entity X through its role in the arrangement described?

**Interpretive Response:** Yes. While Insurer does not have an explicit variable interest in Entity X, the guarantee arrangement with Investor A creates an implicit variable interest in Entity X because it absorbs variability of Entity X.

### 3.4. INTERESTS IN SPECIFIED ASSETS OF A VARIABLE INTEREST ENTITY

**Excerpt from ASC Subtopic 810-10**

**Variable Interest and Interests in Specified Assets of a VIE**

**25-55** A variable interest in specified assets of a VIE (such as a guarantee or subordinated residual interest) shall be deemed to be a variable interest in the VIE only if the fair value of the specified assets is more than half of the total fair value of the VIE’s assets or if the holder has another variable interest in the VIE as a whole (except interests that are insignificant or have little or no variability). This exception is necessary to prevent a reporting entity that would otherwise be the primary beneficiary of a VIE from circumventing the requirement for consolidation simply by arranging for other parties with interests in certain assets to hold small or inconsequential interests in the VIE as a whole. The expected losses and expected residual returns applicable to variable interests in specified assets of a VIE shall be deemed to be expected losses and expected residual returns of the VIE only if that variable interest is deemed to be a variable interest in the VIE.

**25-56** Expected losses related to variable interests in specified assets are not considered part of the expected losses of the legal entity for purposes of determining the adequacy of the equity at risk in the legal entity or for identifying the primary beneficiary unless the specified assets constitute a majority of the assets of the legal entity. For example, expected losses absorbed by a guarantor of the residual value of leased property are not considered expected losses of a VIE if the fair value of the leased property is not a majority of the fair value of the VIE’s total assets.

**3.4.10.10.** The FASB recognized that parties involved with another entity may have interests in only certain specified assets of the entity rather than an interest or interests in the entity as a whole. (Note that the term entity for this purpose also applies to silos of an entity as described further in Section 5.) In that situation, two questions arise. First, how should interests in specified assets of an entity (rather than in the entity as a whole) affect the determination of the entity’s expected losses when considering whether the entity’s equity is sufficient to be considered a voting interest entity? Second, assuming that the entity in which the
interests in specified assets are held is a VIE, how should parties that hold the interests in specified assets be considered in determining whether the entity should be consolidated and, if so, by whom?

3.4.10.20. The FASB ultimately concluded that interests in specified assets of an entity are not considered variable interests in the entity provided that the fair value of the specified assets represents no more than 50% of the fair value of the entity’s total assets and that the holder of the interests in specified assets does not have a variable interest in the overall VIE (unless the variable interest is insignificant or absorbs little or no variability). An interest in specified assets that is not a variable interest in the entity is referred to as a variable interest in specified assets. In addition, the FASB decided that expected losses and expected residual returns from variable interests in specified assets should be excluded from the expected losses and expected residual returns of the entity when considering the adequacy of the entity’s equity and the characteristics of that equity for purposes of determining whether the entity is a VIE.

3.4.10.30. The guidance in ASC paragraphs 810-10-25-55 and 25-56 creates an artificial residual entity (i.e., the entity that remains after removing the interests in specified assets) that is less likely to be a VIE than it would be if variable interests in specified assets were treated as variable interests in the entity. In evaluating whether an entity is a VIE, the entity’s expected losses usually will be lower than they otherwise would be as a result of excluding variable interests in specified assets. This is because variable interests in specified assets often absorb expected losses with respect to those assets. Guarantees of residual values on leased assets and guarantees of cash collections with respect to financial assets absorb expected losses from those assets. Excluding those expected losses from the expected losses of the entity reduces the amount of equity necessary for the residual entity to be considered a voting interest entity. Excluding those interests also may eliminate from consideration, when evaluating the characteristics of the residual entity’s equity, variable interests that would otherwise cause an entity’s equity investors as a group not to have the obligation to absorb the entity’s expected losses if they occur or not to have the right to receive the entity’s expected residual returns if they occur, or both. See Example A.4 for an illustration of the effects of the guidance about interests in specified assets on the calculation of an entity’s expected losses and expected residual returns.

Question 3.4.1: Multiple Interests of an Enterprise in Separate Specified Assets

If an enterprise has different types of interests or provides different types of support to separate groups of specified assets in an entity that individually comprise less than a majority of the fair value of the entity’s assets but collectively comprise a majority of the fair value of the entity’s assets (e.g., if the enterprise provides credit support to a specific third of the entity’s assets and liquidity support to a different third of the entity’s assets), does the
### Question 3.4.2: Multiple Interests of Unrelated Parties in Specified Assets That Collectively Comprise a Majority of an Entity’s Assets

If multiple unrelated parties hold interests in specified assets that individually comprise less than a majority of the fair value of an entity’s assets do those parties have a variable interest in the entity or a variable interest in specified assets of the entity assuming the separate specified assets collectively comprise a majority of the fair value of the entity’s assets?

**Interpretive Response:** They have a variable interest in specified assets of the entity. For example, residual value guarantees may be provided by multiple guarantors on a majority of the fair value of a lessor’s assets, with none of the guarantors individually providing guarantees on an asset or assets whose fair value comprises that majority. Under the guidance in ASC paragraphs 810-10-25-55 and 25-56, expected losses of the entity that are absorbed by those guarantees would be removed from the entity when determining the characteristics and adequacy of its equity under the guidance in ASC paragraphs 810-10-15-14, 25-45, and 25-46. Similarly, individual transferors of financial assets to a transferee entity may provide credit or liquidity support, or both, on a majority of the fair value of the entity’s assets with none of the transferors individually providing support on an asset or assets whose fair value comprises that majority. As a result, expected losses of the entity that are absorbed by that support would be removed from the entity when determining the characteristics and adequacy of its equity under the guidance in ASC paragraphs 810-10-15-14, 25-45, and 25-46. If, however, an individual party (or related party group) provides support on multiple assets whose fair value collectively represents a majority of the fair value of the entity’s assets, expected losses of the entity that are absorbed by that support would be included in the expected losses evaluation when determining the characteristics and adequacy of the entity’s equity under the guidance in ASC paragraphs 810-10-15-14, 25-45, and 25-46.
3.5. FEES PAID TO DECISION MAKERS OR SERVICE PROVIDERS

3.5.10. Determining Whether Fees Paid to Decision Makers or Service Providers are Variable Interests

Excerpt from ASC Subtopic 810-10

<table>
<thead>
<tr>
<th>Decision Maker</th>
</tr>
</thead>
<tbody>
<tr>
<td>An entity or entities with the power to direct the activities of another legal entity that most significantly impact the legal entity’s economic performance according to the provisions of the Variable Interest Entities Subsections of Subtopic 810-10.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Decision-Making Authority</th>
</tr>
</thead>
<tbody>
<tr>
<td>The power to direct the activities of a legal entity that most significantly impact the entity’s economic performance according to the provisions of the Variable Interest Entities Subsections of Subtopic 810-10.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Fees Paid to Decision Makers or Service Providers</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>55-37</strong> Fees paid to a legal entity’s decision maker(s) or service provider(s) are not variable interests if all of the following conditions are met:</td>
</tr>
</tbody>
</table>

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

(b) Subparagraph superseded by Accounting Standards Update No. 2015-02.

(c) The decision maker or service provider does not hold other interests in the VIE that individually, or in the aggregate, would absorb more than an insignificant amount of the VIE’s expected losses or receive more than an insignificant amount of the VIE’s expected residual returns.

(d) The service arrangement includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm’s length.

(e) Subparagraph superseded by Accounting Standards Update No. 2015-02.

(f) Subparagraph superseded by Accounting Standards Update No. 2015-02.

**55-37A** Paragraph superseded by Accounting Standards Update No. 2015-02.

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

(a) The fee arrangement relates to a unique or new service.

(b) The fee arrangement reflects a change in what is considered customary for the services.

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

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

(a) Those related to guarantees of the value of the assets or liabilities of a VIE

(b) Obligations to fund operating losses

(c) Payments associated with written put options on the assets of the VIE

(d) Similar obligations, such as some liquidity commitments or agreements (explicit or implicit) that protect holders of other interests from suffering losses in the VIE.

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

55-37D For purposes of evaluating the conditions in paragraph 810-10-55-37, any interest in an entity that is held by a related party of the decision maker or service provider should be considered in the analysis. Specifically, a decision maker or service provider should include its direct economic interests in the entity and its indirect economic interests in the entity held through related parties, considered on a proportionate basis. For example, if a decision maker or service provider owns a 20 percent interest in a related party and that related party owns a 40 percent interest in the entity being evaluated, the decision maker’s or service provider’s interest would be considered equivalent to an 8 percent direct interest in the entity for the purposes of evaluating whether the fees paid to the decision maker(s) or the service provider(s) are not variable interests (assuming that they have no other relationships with the entity). Indirect interests held through related parties that are under common control with the decision maker should be considered the equivalent of direct interests in their entirety. The term related parties in this paragraph refers to all parties as defined in paragraph 810-10-25-43, with the following exceptions:
(a) An employee of the decision maker or service provider (and its other related parties), except if the employee is used in an effort to circumvent the provisions of the Variable Interest Entities Subsections of this Subtopic.

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

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

55-38 Fees paid to decision makers or service providers that do not meet all of the conditions in paragraph 810-10-55-37 are variable interests.

3.5.10.10. The guidance in ASC paragraph 810-10-55-37 and paragraphs 55-37B through 55-37D specifies how to determine whether a decision maker or service provider receives a fee that is a variable interest in a VIE and, therefore, must evaluate whether it is the primary beneficiary of the VIE. It emphasizes a consideration of various qualitative factors related to the nature of services provided and fees charged when determining whether a variable interest exists.

3.5.10.20. To achieve its primary objective to limit the circumstances in which investment managers and similar entities are required to consolidate the entities that they manage (see paragraph 1.1.40.10 for additional background information), the FASB decided with the issuance of Accounting Standards Update No. 2015-02 (ASU 2015-02), Amendments to the Consolidation Analysis, to eliminate some of the criteria under which fees are considered a variable interest. The FASB also decided to change how related parties are considered in the evaluation, which is discussed beginning at paragraph 3.5.20.10. Before ASU 2015-02, fees paid to a decision maker or service provider were considered a variable interest unless they met all of the following conditions in addition to the three conditions described in ASC paragraph 810-10-55-37:

- Substantially all of the fees are at or above the same level of seniority as other operating liabilities of the VIE that arise in the normal course of the VIE’s activities (e.g., trade payables);
- The anticipated fees are insignificant relative to the amount of the VIE’s anticipated economic performance; and
- The anticipated fees are expected to absorb an insignificant amount of the variability associated with the VIE’s anticipated economic performance.
The FASB’s decision to eliminate these three conditions under which fees are considered a variable interest in a VIE makes it less likely that a decision maker or service provider will be the primary beneficiary of a VIE solely due to its fee arrangement. A decision maker whose fee is not a variable interest cannot be the primary beneficiary of a VIE.

3.5.10.30. A decision maker or service provider may conclude that it does not have a variable interest in an entity even if no substantive kick-out rights exist. Observations with respect to the criteria in ASC paragraph 810-10-55-37 include:

- When evaluating whether the fees and terms of the arrangement are commensurate and customary with the nature of services being rendered under ASC subparagraphs 810-10-55-37(a) and 55-37(d), enterprises may need to assess external contracts and business relationships (i.e., those entered into by parties outside of the relationship). A fee would not presumptively be considered a variable interest when similar fee arrangements do not exist if the fee arrangement relates to a unique or new service or if it reflects a change in what is considered customary for the services. In addition, the magnitude of a fee would not be determinative in evaluating the criteria.

- In addition to being considered a variable interest in the entity, fees for services rendered over a specified period in the future at a rate above the market rate at the time of payment typically would reduce the entity’s equity investment at risk when evaluating ASC subparagraph 810-10-15-14(a) because the above-market component is designed as a mechanism to return capital.

The criteria do not apply to fees or payments in connection with agreements that expose the decision maker or service provider to risk of loss in the VIE, such as guarantees of the value of the assets or liabilities of a VIE, obligations to fund operating losses, etc. Fees in those arrangements are automatically considered variable interests under the guidance in ASU 2015-02. However, the consideration of such fees is not likely to be particularly impactful. If the decision maker or service provider meets the criteria to be the primary beneficiary of a VIE on the basis of its decision-making rights and the risks to which it is exposed through its variable interests, considering the fees a variable interest is unlikely to change that conclusion. Likewise, if the decision maker or service provider does not meet the criteria to be the primary beneficiary of a VIE on the basis of its decision-making rights and the risks to which it is exposed through its variable interests, considering the fees a variable interest is unlikely to change that conclusion. This is because those fees are unlikely to provide the right to receive benefits that could potentially be significant to the VIE when the arrangement does not obligate the decision maker or service provider to absorb losses that could potentially be significant to the VIE.
• Entities may need to consider quantitative elements of their fee arrangements and other interests (i.e., their level of significance); however, a quantitative analysis should not be the sole factor considered.

• Interests held by related parties should be treated as described beginning at paragraph 3.5.20.10.

3.5.10.40. The guidance in ASC paragraph 810-10-55-37 is intended to address whether a decision maker or service provider functions more like an agent or more like a principal because the FASB was concerned that entities operating in a fiduciary-type role may otherwise be required to consolidate an entity if they directed the activities most significant to the entity’s economic performance. Paragraph BC76 of ASU 2015-02 states:

“The Board concluded that the revised guidance for determining whether decision-maker fees and service provider fees represent a variable interest in a VIE in paragraphs 810-10-55-37 through 55-38 is sufficient for determining whether an enterprise is acting in a fiduciary role in relation to a VIE. In other words, the Board expects that the fees paid to an enterprise that acts solely as a fiduciary or agent should typically not represent a variable interest in a VIE because those fees would typically meet the conditions in paragraphs 810-10-55-37 through 55-38, as amended in this Update. If an enterprise’s fee does not meet those conditions, the Board reasoned that an enterprise is not solely acting in a fiduciary role. If the enterprise has (a) the power to direct the activities that most significantly impact the economic performance of the entity and (b) the obligation to absorb losses or the right to receive benefits of the entity that could potentially be significant to the VIE, that enterprise would be the primary beneficiary of the entity. The Board observed that the conditions in paragraphs 810-10-55-37 through 55-38 would allow an enterprise to hold another variable interest in the entity that would absorb an insignificant amount of the entity’s expected losses or receive an insignificant amount of the entity’s expected returns, provided the fee paid to the decision maker or service provider did not expose the entity to risk of loss as indicated in paragraph 810-10-55-37C. The Board concluded that an enterprise holding such an interest would still be acting in a fiduciary role as long as the other conditions in paragraphs 810-10-55-37 through 55-38 were met and that enterprise would not be the primary beneficiary of the entity. Once a decision maker determines that its fees meet the remaining conditions in paragraphs 810-10-55-37 through 55-38, the decision maker would not need to continue with its consolidation assessment.”

3.5.10.50. Although paragraph BC76 discusses ASC paragraph 810-10-55-37 in the context of whether an enterprise is acting solely as a fiduciary, it has become apparent, since the issuance of ASU 2009-17 and through the issuance of ASU 2015-02, that the FASB intended, and continues to intend, to establish a test for whether an enterprise is acting at least as much in its own self-interest as in the interest of unrelated parties (which the Board views as functioning more like a
principal) or primarily in the interest of unrelated parties (which the Board views as functioning more like an agent).

3.5.10.60. The following flowchart depicts the evaluation of whether fees paid to a decision maker or service provider are variable interests.

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1 For purposes of evaluating whether other interests in the VIE held by the decision maker or service provider and its related parties absorb more than an insignificant amount of the VIE's expected losses or expected residual returns, interests held by related parties under common control with the VIE are considered on a proportionate basis, and only if the decision maker or service provider holds an economic interest in the related party. Interests held by related parties under common control with the decision maker or service provider are considered in their entirety if the decision maker or service provider holds an economic interest in the related party and in certain other circumstances. See additional interpretive guidance starting at paragraph 3.5.20.10.
Question 3.5.10.1: Evaluating Whether Decision Maker or Service Provider Fees Are At-Market and Commensurate

How should a reporting enterprise determine whether the fees it receives as a decision maker or service provider are commensurate with the services provided and level of effort required to provide those services (ASC subparagraph 810-10-55-37(a)) and include only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm’s-length (ASC subparagraph 810-10-55-37(d))? 

Interpretive Response: A reporting enterprise will need to apply judgment in evaluating whether the conditions are met. The evaluation may need to include consideration of arrangements for other similar services. The objective of the conditions in ASC subparagraphs 810-10-55-37(a) and (d) is to establish that the fees paid to a decision maker or service provider:

(a) Are only compensation for its services,
(b) Are not affected by any other variable interests that the decision maker or service provider holds in the entity – i.e., are consistent with compensation that would be provided to an enterprise that acts solely as a fiduciary or agent, and
(c) Do not convey substantially all of the entity’s pre-fee net income to the decision maker or service provider.

We believe there are two scenarios where this objective presumptively would be met. In both scenarios, the presumption generally would be overcome when the fees comprise substantially all of the entity’s net income excluding the fees as discussed in ASC paragraphs 810-10-55-205Z through 55-205AI.

The first scenario is when a decision maker’s only involvement with an entity is through its fee arrangement. The second scenario is when the decision maker holds other interests in the entity, but interests of the same class also are held by one or more unrelated parties that do not receive fees from the entity (e.g., the decision maker and three unrelated parties each hold part of the entity’s residual equity). In either scenario, the conditions in ASC subparagraphs 810-10-55-37(a) and (d) presumptively would be met.

If a decision maker has other involvement with the entity and no other party holds interests of the same class, we believe further analysis is required. This includes considering whether the arrangement was structured to reduce the decision maker’s other interests so that they absorb insignificant variability in exchange for an increase in the decision maker’s fees. When further analysis is required, a decision maker generally will need to either compare its fee arrangement to other arrangements involving similar services that meet either of the scenarios described above where the presumption is not overcome, or compare the return profile of its other interests to that of similar stand-alone interests in other entities.
3.5.10.70. At the 2015 AICPA National Conference on Current SEC and PCAOB Developments, a member of the SEC staff discussed the evaluation of whether a decision maker’s fees are at-market and commensurate. An excerpt from the speech follows:

**Excerpt from Speech by Christopher D. Semesky**

I would also like to address the evaluation of whether a decision-maker’s fee arrangement is customary and commensurate. This evaluation is done at inception of a service arrangement or upon a reconsideration event, such as the modification of any germane terms, conditions or amounts in the arrangement.

The determination of whether fees are commensurate with the level of service provided often may be determined through a qualitative evaluation of whether an arrangement was negotiated on an arm’s length basis when there are no obligations beyond the services provided to direct the activities of the entity being evaluated for consolidation. This analysis requires a careful consideration of the services to be provided by the decision-maker in relation to the fees.

The evaluation of whether terms, conditions and amounts included in an arrangement are customarily present in arrangements for similar services may be accomplished in ways such as benchmarking the key characteristics of the subject arrangement against other market participants’ arrangements negotiated on an arm’s length basis, or in some instances against other arm’s length arrangements entered into by the decision-maker. There are no bright lines in evaluating whether an arrangement is customary, and reasonable judgment is required in such an evaluation. A decision-maker should carefully consider whether any terms, conditions, or amounts would substantively affect the decision-maker’s role as an agent or service provider to the other variable interest holders in an entity.

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**Question 3.5.10.2: General Partner Carried Interest or Promote**

If the general partner of a limited partnership receives a fee that includes a carried interest or promote that allows the general partner to participate significantly in the entity’s returns, does the general partner’s fee represent a variable interest in the entity?

**Interpretive Response:** Not necessarily. ASU 2015-02 differentiates between economic benefits that a decision maker receives through fees versus those that it obtains through variable interests that are not characterized as fees. However, it is not unusual for performance-based compensation to be embedded in an equity or similar interest that is held by an investment.
manager or other decision maker in the form of a disproportionately higher share of the entity’s profits and/or distributions once a targeted return has been achieved by the entity. For example, a general partner with a 1% general partner interest may receive 20% of a partnership’s total distributions once the limited partners have received a return of their capital contributions and a specified compounded annual return on their capital contributions.

Significant judgment will often be necessary to identify whether an equity or similar interest held by a decision maker includes a performance fee component and, if so, the terms of the performance fee component. In general, when an equity or similar interest is transferable by a decision maker while remaining the entity’s decision maker, this strongly indicates that there is no embedded fee component in that interest. In some instances, there may be insufficient information in an entity’s governing agreements or marketing materials to determine whether an equity or similar interest includes a performance fee component. In those instances, we believe it would be acceptable to determine the component of the equity or similar interest that represents a fee component by using a residual approach. Under that approach, the component of the equity or similar interest that is considered an embedded fee would be the amount that combined with any stated fees paid to the decision maker meets the conditions in ASC subparagraphs 810-10-55-37(a) and 55-37(d). See Question 3.5.10.1 for guidance on evaluating whether fees meet the conditions in ASC subparagraphs 810-10-55-37(a) and 55-37(d).

The portion of an equity or similar interest that excludes the fee component (if any) would be assessed for significance under the condition in ASC subparagraph 810-10-55-37(c). In evaluating whether a general partner meets the condition in ASC subparagraph 810-10-55-37(c), we believe a promote or carried interest that is initially an embedded fee component of the general partner interest would not represent another interest held by the general partner unless and until it is issued in the form of an additional partnership interest that is retained by the general partner or increases the general partner’s existing equity interest(s) (i.e., capital balance) and is not subject to reversal (i.e., the general partner is not required to surrender some or all of the equity interest) if performance of the entity declines in the future. We believe a service provider should have the right to sell or redeem a carried interest that is not subject to reversal.

When the general partner and its related parties have other interests in the limited partnership, the fee would not be a variable interest if the variability absorbed through the general partner’s other direct and indirect interests is insignificant (e.g., not more than 10% of the VIE’s expected variability). For additional guidance on how to evaluate the effect of interests held by related parties of the general partner see Question 3.5.20.1. For additional guidance on evaluating the significance of other interests see Question 3.5.10.3. It will be important for reporting enterprises to ensure that their processes and internal controls are designed to ensure there is ongoing monitoring of the level of other interests held directly or indirectly through related parties.
Accounting for Carried Interest After Topic 606 Is Effective and the Implication to the Consolidation Analysis

If a general partner does not consolidate the limited partnership, it generally accounts for its fee (including its performance fee in the form of a carried interest) based on the guidance in ASC paragraph 605-20-S99-1 (previously EITF Topic D-96), which provides two acceptable methods for income recognition. Topic D-96 also included guidance permitting entities that previously applied the equity method to these arrangements to continue to do so. Because this guidance is expected to be withdrawn by the SEC when Topic 606 becomes effective, stakeholders have raised questions about whether carried interest arrangements are within the scope of Topic 606 or, because generally they are in-form equity, they should be accounted for as an ownership interest in the investee entity.

Members of the FASB/IASB Revenue Recognition Transition Resource Group (TRG) considered this issue at their April 2016 meeting. FASB members present at the meeting indicated that the Board discussed performance fees in asset management contracts when developing Topic 606. As summarized in paragraphs 6 through 10 of TRG Agenda Ref No. 55: April 2016 Meeting – Summary of Issues Discussed and Next Steps, all seven FASB members present at the meeting expressed the view that performance fees in the form of carried interest arrangements were intended to be within the scope of Topic 606.

The SEC Observer at the meeting indicated that the SEC staff would accept an application of Topic 606 for these arrangements. However, he also noted that applying an ownership model to these arrangements, rather than Topic 606, may be acceptable based on the specific facts and circumstances. If an entity were to apply an ownership model, then the SEC staff would expect the full application of the ownership model, including an analysis of the consolidation guidance in Topic 810, the equity method of accounting under Topic 323, or other relevant guidance. Based on informal discussions with the SEC staff, we understand that the SEC staff would not object to the view that the carried interest would be evaluated as a performance fee rather than an interest in the fund itself when making an assessment of whether it is a variable interest under Topic 810.

The SEC Observer did not elaborate on the nature of the facts and circumstances that in the SEC staff’s view would require application of Topic 606 to these arrangements. Based on informal discussions with the SEC staff following the TRG meeting, we are not aware of any examples in which the SEC staff believe applying an ownership model would be unacceptable when the performance fee is in the form of equity (i.e., carried interest).

If the SEC staff withdraws ASC paragraph 605-20-S99-1 (Topic D-96) when Topic 606 becomes effective, based on our understanding of the SEC staff’s views, we believe both private and public companies may make an accounting policy election when they adopt Topic 606 to account for performance-based
fees in the form of a capital allocation by applying either (a) the revenue recognition guidance in Topic 606, or (b) an equity ownership model using the guidance in Topic 323, Topic 810, or other relevant guidance. Either accounting policy selected should be consistently applied. Based on our current understanding of the views of the FASB and SEC staff, if a company elects to initially apply Topic 606 to these arrangements, we believe it generally would be difficult to support a conclusion that it is preferable to change to an ownership model at a future date. Our current understanding may be affected by future standard setting or regulatory developments that may cause our views to change. If those circumstances arise we will update our guidance accordingly.

If an entity determines it is appropriate to apply an ownership model (e.g., Topic 323) when ASC paragraph 605-20-S99-1 (Topic D-96) is rescinded, it should apply the guidance in Topic 250 for a change in accounting and not the transition guidance in Topic 606. In that case, presentation and disclosure of the equity income from these arrangements would also be separated from revenue from arrangements that are accounted for under Topic 606.

Example 3.5.10.1: Investment Fund with Performance Fee Paid in Cash

An investment fund is a VIE created to hold a portfolio of asset-backed securities. Entity A is the general partner and asset manager of the fund and contributed nominal capital in exchange for a 1% interest in the fund. Multiple unrelated parties hold limited partnership interests that represent 99% of the fund's equity capital. For its services, Entity A earns an annual management fee of 2% of the fund's net asset value and a performance fee of 20% of the fund's profits after the fund has achieved a compounded annual rate of return of 10% on total capital contributions, which may be considered an expense or equity distribution (i.e., carried interest) from the fund's perspective. The management and performance fee is paid in cash. Entity A holds none of the limited partnership interests and has the contractual right to direct the activities that most significantly impact the fund's economic performance. The limited partners have no substantive kick-out rights or participating rights over Entity A.

At the fund's inception, Entity A evaluates the management and performance fees and determines that they meet the conditions in ASC subparagraphs 810-10-55-37(a) and 55-37(d). The condition in ASC subparagraph 810-10-55-37(c) is also met because Entity A's 1% interest is insignificant. Therefore, Entity A is deemed to be acting in a fiduciary capacity and its asset management fee would not be considered a variable interest. Accordingly, Entity A would not consolidate the fund.

For reasons discussed further in Question 3.5.30.1, after the fund's inception, Entity A would not need to reassess whether its asset management fee is a variable interest if there is no change or renegotiation of the terms of the fee
arrangement and it did not acquire additional interests in the fund or increase its capital balance through reinvestment of distributions.

**Example 3.5.10.2: Investment Fund with Performance Fee Paid in Equity**

Modifying the facts in Example 3.5.10.1, assume the performance fee is paid through the issuance of additional equity interests rather than cash, primarily for tax purposes. Entity A may elect to sell or redeem the equity interests received (i.e., it is not required to retain the equity interest).

At the fund's inception, Entity A evaluates the management and performance fees and determines that they meet the conditions in ASC subparagraphs 810-10-55-37(a) and 55-37(d). The condition in ASC subparagraph 810-10-55-37(c) is also met because Entity A's 1% interest is insignificant. Therefore, Entity A is deemed to be acting in a fiduciary capacity and its asset management fee would not be considered a variable interest. Accordingly, Entity A would not consolidate the fund.

Assume that two years after the fund's inception Entity A receives an 11% equity interest in the fund as a performance fee. Entity A elects to retain the equity interest even though it is not required to do so. The fact that Entity A retains the equity interest in this situation is substantively the same as electing to make an equity investment in the fund. As such, the equity interest would be considered another interest to be evaluated under ASC subparagraph 810-10-55-37(c). Assuming that the 11% equity interest absorbs more than an insignificant amount of the fund's expected losses and/or expected residual returns, Entity A would be required to consolidate the fund.

**Example 3.5.10.3: Investment Fund with Performance Fee Allocated to General Partner Capital Account**

Modifying the facts in Example 3.5.10.1, assume the asset management agreement does not identify a performance fee for Entity A's services. In addition to its pro-rata allocation, Entity A's general partner interest entitles it to receive 20% of the fund's profits after the fund has achieved a compounded annual rate of return of 10% on total capital contributions via an allocation to its general partner capital account. From that point forward Entity A's share of the fund's operating results reflects the increase in its share of the fund's total capital.

At the fund's inception, Entity A evaluates the management fees and determines that to meet the conditions in ASC subparagraphs 810-10-55-37(a) and 55-37(d) they should include a performance fee component that is embedded in its general partner interest. By reference to other agreements for similar services, Entity A determines that the performance fee component of the arrangement is the disproportionate share of the fund's profits (i.e., 20%)
that is allocated to the general partner capital account after the fund has achieved a compounded annual rate of return of 10%. Entity A excludes that component of the general partner interest in its evaluation of the condition in ASC subparagraph 810-10-55-37(c). After excluding that component of its general partner interest, Entity A concludes that the condition in ASC subparagraph 810-10-55-37(c) is met because Entity A’s 1% interest is insignificant. Therefore, Entity A is deemed to be acting in a fiduciary capacity and its asset management fee would not be considered a variable interest. Accordingly, Entity A would not consolidate the fund.

Assume that two years after the fund’s inception Entity A’s capital account is increased by 11% because the fund’s performance has exceeded a 10% compounded annual rate of return. The increase in Entity A’s capital account is not subject to reversal (i.e., Entity A is not required to surrender some or all of the additional capital) if performance of the fund declines in the future but is subject to an attribution of operating losses, if any, of the fund (pro rata along with other partnership interests). At that point, the non-fee component of Entity A’s general partner interest to be evaluated for significance under ASC subparagraph 810-10-55-37(c) would include the additional capital balance resulting from the performance fee allocation. Whether the condition in ASC subparagraph 810-10-55-37(c) is met depends on whether Entity A’s new total equity interest (including the additional capital balance resulting from the performance fee allocation) absorbs more than an insignificant amount of the fund’s expected losses and/or expected residual returns. If it does, Entity A’s fees would be considered a variable interest and Entity A would be required to consolidate the fund upon the increase in its capital account.

Example 3.5.10.4: Master Limited Partnership

A master limited partnership (MLP) that is a VIE is formed to own and operate the infrastructure necessary to transport, refine, and store oil and gas for end-users. The MLP is managed by a general partner that is responsible for overseeing the business operations of the MLP on behalf of the limited partners. The general partner has the contractual right to direct the activities that most significantly impact the MLP’s economic performance. The limited partners do not have substantive kick-out rights or participating rights over the general partner.

The limited partner interests are issued in the form of units that are publically traded. At inception of the MLP, the general partner receives a 2% general partner interest in the MLP as an up-front fee and ongoing fees for managing the MLP’s assets. The general partner also receives Incentive Distribution Rights (IDRs) that entitle it to receive an increasingly higher percentage of the MLP’s incremental cash flows once the payout on the limited partner units reaches certain predetermined targets. (After the limited partner units receive a quarterly distribution, the IDRs receive between 2% to 50% of remaining available cash flows.) The MLP’s IDR schedule is structured in a manner that
encourages the general partner to drive distributions to the limited partner units. The IDRs are freely transferable to third parties, are nonvoting if they are held by the general partner, and have limited voting rights if held by third parties.

At the MLP’s inception, the general partner evaluates the management fees and determines that they meet the conditions in ASC subparagraphs 810-10-55-37(a) and 55-37(d) without considering a portion of the IDRs (i.e., no portion of the IDRs is considered a fee component). The fact that the IDRs are freely transferable strongly indicates that there is no embedded fee component in that interest. Whether the condition in ASC subparagraph 810-10-55-37(c) is met depends on whether the IDRs and general partner interest absorb more than an insignificant amount of the MLP’s expected losses and/or expected residual returns. If they do, the general partner’s fees would be considered a variable interest and the general partner would be required to consolidate the MLP.

**Question 3.5.10.3: Evaluating Whether the Insignificant Criteria Are Met**

When applying ASC paragraph 810-10-55-37, how should an enterprise determine if it holds other interests in the VIE that individually, or in the aggregate, absorb more than an insignificant amount of the entity’s expected losses or receive more than an insignificant amount of the entity’s expected residual returns?

**Interpretive Response:** ASC Subtopic 810-10 does not provide a quantitative threshold for determining whether an interest would absorb or receive more than an insignificant amount of the VIE’s expected losses or expected residual returns. Because the underlying principle of ASC paragraph 810-10-55-37 is to determine whether the enterprise is acting in a fiduciary capacity on behalf of the VIE, the Board concluded that all involvements with the VIE should be analyzed.

The evaluation of insignificant under ASC subparagraph 810-10-55-37(c) requires significant judgment and consideration of all relevant facts and circumstances. However, if the variability absorbed by the decision maker’s other variable interests does not exceed 10% of the VIE’s expected variability, we believe it may be reasonable to presume that these conditions are met.

Enterprises should consistently analyze similar fee arrangements for purposes of ASC subparagraph 810-10-55-37(c). Specifically, with the adoption of ASU 2015-02, it will be particularly important to consider whether arrangements have been structured to reduce a decision maker’s other variable interests so that they absorb insignificant variability of the VIE in exchange for an increase in the decision maker’s fees. It will also be important to determine whether a fee arrangement relates to a unique service or reflects a change in what is considered customary for the services.
Question 3.5.10.4: At Risk Equity That Absorbs *More Than an Insignificant Amount* of Variability

Does the conclusion that an enterprise’s equity investment in a VIE is *at risk* under ASC subparagraph 810-10-15-14(a) automatically mean that this equity investment would *absorb more than an insignificant amount* of the VIE’s variability?

**Interpretive Response:** ASC subparagraph 810-10-55-37(c) indicates that a fee paid to a decision maker or service provider (collectively, the decision maker) would represent a variable interest if the decision maker (including related parties as described beginning at paragraph 3.5.20.10) holds other interests in the VIE that would absorb "more than an insignificant amount of the VIE’s expected losses or receive more than an insignificant amount of the VIE’s expected residual returns." We do not believe that all at risk equity in a VIE would necessarily absorb more than an insignificant amount of variability and therefore do not believe there is symmetry between the concepts in ASC subparagraphs 810-10-55-37(c) and 15-14(a). That is, a decision maker may hold a substantive at risk equity investment in a VIE, but conclude that this interest does not absorb a more than an insignificant amount of variability. For example, a 1% interest in the at risk equity of a VIE may be considered substantive under ASC subparagraph 810-10-15-14(a), but may not absorb variability that is more than insignificant to the entity.

Question 3.5.10.5: Fees That Are a Fixed Percentage of Assets under Management

Would an investment manager’s fee that is calculated as a fixed percentage of the fair value of the assets of a VIE be a variable interest in the entity if the investment manager has no other variable interests in the VIE and the fee rate is a market rate?

**Interpretive Response:** Generally, no. While all facts and circumstances should be considered, we believe the FASB did not intend for market rate fees calculated as a fixed percentage of the assets under management to be a variable interest based on the conditions in ASC paragraph 810-10-55-37 when the manager holds no other variable interests in the VIE.

Question 3.5.10.6: Clean-Up Calls

When evaluating fees paid to decision makers or service providers and the conditions in ASC paragraph 810-10-55-37, is a clean-up call, as defined by ASC Topic 860 (as amended by FASB Accounting Standards Update No. 2009-16, *Accounting for Transfers of Financial Assets*) (originally issued as
FASB Statement No. 166, *Accounting for Transfers of Financial Assets – an Amendment of FASB Statement No. 140*, held by the transferor of financial assets into a VIE a variable interest in the VIE?

**Interpretive Response:** Generally, no. We believe that if the clean-up call as defined by ASC Topic 860 does not preclude a transfer of financial assets from satisfying the conditions to be accounted for as a sale in ASC Topic 860, it would be considered a term of the servicing arrangement that, if customary, would not necessarily be a variable interest in the VIE.

However, enterprises should carefully consider the point at which servicing the assets becomes burdensome in relation to the benefits of servicing when considering whether the terms of the clean-up call are customary. We believe that this analysis should be performed on entering into the servicing arrangement and should not necessarily rely on past practice, where the cost of servicing has generally been considered burdensome at or below 10% of the original principal balance.

**Question 3.5.10.7: Standard Representations and Warranties**

When evaluating fees paid to decision makers or service providers under the conditions in ASC paragraph 810-10-55-37, are standard representations and warranties of the transferor of financial assets into a VIE a variable interest in the VIE?

**Interpretive Response:** Generally, no. We believe standard representations and warranties (as defined in ASC Section 860-10-20) of a transferor of financial assets into a VIE that do not preclude the transfer from satisfying the conditions in ASC Topic 860 to be accounted for as a sale would be considered a term or condition of the servicing arrangement that, if customary, would not necessarily be a variable interest in the VIE.

**Question 3.5.10.8: Servicing Advances**

When evaluating fees paid to decision makers or service providers under the conditions in ASC paragraph 810-10-55-37, are servicing advances made to a VIE a variable interest in the VIE?

**Interpretive Response:** Generally, no. We believe that servicing advances would be considered a term of the servicing arrangement that, if customary, would not necessarily be a variable interest in the VIE.

**Question 3.5.10.9: Market Making and Liquidity Arrangements**

How should an interest held for market-making purposes or as a result of a liquidity event under a liquidity arrangement be evaluated when determining...
whether a variable interest is *insignificant* under ASC subparagraph 810-10-55-37(c)?

**Background:** A decision maker or service provider may act as a market maker in certain circumstances (e.g., issuance of public debt). As a market maker, the enterprise is expected to acquire and subsequently resell some of the interests held on initial issuance. Alternatively, a decision maker or service provider may enter into a liquidity arrangement with the entity under which the decision maker or service provider is obligated to acquire a specified portion or all of the entity’s interests on a liquidity event. The price paid for those interests may or may not represent fair value.

**Interpretive Response:** The reason why a decision maker or service provider holds the interest generally is not relevant in evaluating whether the interest absorbs more than insignificant expected losses or expected residual returns of an entity.

Assume that Bank A receives a base fee (a fixed percentage of assets under management) and currently holds a 30% interest in the most senior tranche of debt instruments issued by CDO. Bank A is acting as a market maker for the debt and therefore holds its investment in CDO’s debt securities to facilitate trading for those securities. Bank A plans to resell the debt securities in the near term.

Bank A will need to evaluate all facts and circumstances to determine whether its investment in the debt securities as a market maker would cause its fee to not meet the criteria in ASC paragraph 810-10-55-37. ASC subparagraph 810-10-55-37(c) requires a decision maker or service provider to determine whether a non-fee variable interest absorbs more than an insignificant amount of the entity’s expected losses or receives more than an insignificant amount of the entity’s expected residual returns. The outcome of this analysis depends on the nature of CDO’s assets and the variability of CDO absorbed by the subordinated tranches at the time that Bank A acquires the investment interest in the most senior tranche (which depends, in part, on their fair value in relation to the fair value of CDO’s assets at that time). We do not believe the fact that Bank A holds the investment only in a market-making capacity would affect the outcome of the evaluation.

The analysis of an interest held as a result of a liquidity event under a liquidity arrangement would be the same as the analysis of an interest held for market-making purposes if the price paid under the liquidity arrangement represents fair value. If the price the decision maker or service provider is obligated to pay on a liquidity event does not represent fair value, the liquidity arrangement may represent a guarantee that gives rise to a variable interest even without the occurrence of a liquidity event. If so, the decision maker or service provider would also need to evaluate the significance of that variable interest under ASC subparagraph 810-10-55-37(c), which would depend on the likelihood of a liquidity event and the extent to which the price paid would exceed fair value. Also see Question 6.3.20.2.
Question 3.5.10.10: Indirect Interests and Separate Accounts

How should a reporting enterprise evaluate whether to consolidate an entity that is also owned by a separate account in which the reporting enterprise’s related parties hold an interest?

**Background:** ASC subparagraphs 944-80-25-3(e) – 25-3(f) have the following guidance, which is applicable under U.S. GAAP prior to the effective date of ASU 2015-02:

(e) Except as described in paragraph (f), the insurer shall not do either of the following when assessing whether the insurer is required to consolidate an investment held by a separate account:

1. Consider any separate account interests held for the benefit of policy holders to be the insurer’s interests
2. Combine any separate account interests held for the benefit of policy holders with the insurer’s general account interest in the same investment.

(f) Separate account interests held for the benefit of a related party policy holder shall be combined with the insurer’s general account interest when the Variable Interest Entities Subsections of Subtopic 810-10 require the consideration of related parties. For this purpose, a related party includes any party identified in paragraph 810-10-25-43 other than:

1. An employee of the decision maker or service provider (and its other related parties), except if the employee is used in an effort to circumvent the provisions of Subtopic 810-10
2. An employee benefit plan of the decision maker or service provider (and its other related parties), except if the employee benefit plan is used in an effort to circumvent the provisions of Subtopic 810-10.

**Interpretive Response:** ASU 2015-02 did not amend the guidance in ASC subparagraphs 944-80-25-3(e) – 25-3(f). Therefore, the consolidation analysis related to an investment held by a separate account is affected only by the changes the ASU makes to the related party guidance. In other words, the ASU’s changes to related party guidance could affect the analysis for (a) determining whether an insurer has a variable interest in an investment held by a separate account (ASC paragraph 810-10-55-37) and (b) determining the primary beneficiary of an investment held by a separate account.

If an interest in a separate account is held by a related party under common control with the insurer, the related party’s indirect interest in the separate account’s investment would be included in its entirety by the insurer in evaluating the condition in ASC subparagraph 810-10-55-37(c) if the decision...
Consolidation of Variable Interest Entities, Section 3

maker holds an economic interest in the related party and in certain other circumstances (see Question 3.5.20.1). If an interest in a separate account is held by a related party that is not under common control with the insurer, the related party’s indirect interest in the separate account’s investment would be included by the insurer on a proportionate basis in evaluating the condition in ASC subparagraph 810-10-55-37(c) only if the insurer holds an economic interest in the related party.

If the insurer holds an economic interest in a related party under common control that has an interest in the separate account, then the related party’s indirect interest in the separate account’s investment would be included in its entirety by the insurer in evaluating whether it is the primary beneficiary of the separate account’s investment before the adoption of ASU 2016-17, Interests Held through Related Parties That Are under Common Control. After the adoption of ASU 2016-17, an insurer that holds an economic interest in a related party under common control that has an interest the separate account’s investment would include the related party’s interest on a proportionate basis in its primary beneficiary evaluation.

If the insurer holds an indirect interest in a related party not under common control that has an interest in the separate account, then the related party’s indirect interest in the separate account’s investment is included on a proportionate basis by the insurer in evaluating whether it is the primary beneficiary of the separate account’s investment.

Also see Question 7.3.10.1 for guidance about how a decision maker whose fee is a variable interest in a VIE under ASC paragraph 810-10-55-37 should consider interests in the VIE held by related parties when evaluating whether it is the primary beneficiary of the VIE, including the changes resulting from ASU 2016-17.

3.5.20. Interests Held by Related Parties

3.5.20.10. ASU 2015-02 changes the way in which the interests of related parties are considered in evaluating whether fees paid to a decision maker or service provider represent a variable interest. Before issuance of ASU 2015-02, interests held by related parties were treated as an entity’s own interests for purposes of this evaluation. The FASB’s decisions about the effect of related party interests on VIE consolidation evaluations aligns the VIE consolidation guidance more closely with the guidance for consolidation of entities other than VIEs. In addition, the decisions about the effect of related party interests on the evaluation of whether a decision maker’s fees represent a variable interest (and on the primary beneficiary determination – see Subsection 6.3) further reduce the likelihood that a decision maker will be the primary beneficiary of a VIE.

3.5.20.20. See Section 7, Related Parties and De Facto Agency Relationships, for guidance about how a decision maker whose fee is a variable interest in a VIE under ASC paragraph 810-10-55-37 should consider interests in the VIE.
Question 3.5.20.1: Evaluating Interests Held by Related Parties

How should a reporting enterprise consider interests in an entity held by related parties when evaluating whether the fees it receives as a decision maker or service provider to the entity are a variable interest?

Interpretive Response: Interests held through related parties affect the evaluation of the criterion in ASC subparagraph 810-10-55-37(c). We believe the reporting enterprise should consider interests held by a related party under common control in their entirety in evaluating that criterion only if the decision maker holds an economic interest in the related party under common control.

[Note: In June 2017, the FASB issued a proposed ASU, Targeted Improvements to Related Party Guidance for Variable Interest Entities. Under the proposed amendments, indirect interests held through related parties in common control arrangements would be considered on a proportionate basis in determining whether fees paid to decision makers or service providers are variable interests. This is consistent with (a) how indirect interests held through related parties NOT under common control are considered when evaluating the significance of a decision maker’s other interests (see below) and (b) how indirect interests held through related parties under common control are considered when determining whether an entity is a VIE’s primary beneficiary. Comments on the proposal were due September 5, 2017.

An interest in the VIE held by a related party not under common control with the decision maker should be included in evaluating the significance of the decision maker’s other interests under ASC subparagraph 810-10-55-37(c) on a proportionate basis only if the decision maker holds an economic interest in the related party.

Economic interests in related parties would include any variable interest held by the reporting enterprise in the related party and would not be limited to ownership interests. For interests in a related party other than common equity (e.g., preferred stock, convertible debt), judgment will be needed when determining the amount of the reporting enterprise’s proportionate interest in the entity held through a related party. In some instances, an analysis of the reporting enterprise’s share of the related party’s expected losses and expected residual returns together with the related party’s share of the entity’s expected losses and expected residual returns may be necessary to make this determination.

The conclusion about how interests held by related parties under common control with the decision maker should be considered in determining whether a decision maker’s fee is a variable interest was confirmed by the SEC staff at the 2015 AICPA National Conference on Current SEC and PCAOB Developments. An excerpt from the speech follows:
The next topic I would like to address is the evaluation of whether a decision-maker’s fee constitutes a variable interest under the FASB’s updated consolidation guidance.2 After considering a number of questions posed by registrants, I would like to share with you several observations regarding implementation of the new guidance.

For purposes of illustration consider an entity that has four unrelated investors with equal ownership interests, and a manager that is under common control with one of the investors. The manager has no direct or indirect interests in the entity other than through its management fee, and has the power to direct the activities of the entity that most significantly impact its economic performance.

In this simple example, if the manager’s fee would otherwise not meet the criteria to be considered a variable interest, the fact that an investor under common control with the manager has a variable interest that would absorb more than an insignificant amount of variability would not by itself cause the manager’s fee to be considered a variable interest. The guidance to consider interests held by related parties when evaluating whether a fee is a variable interest specifically refers to instances where a decision-maker has an indirect economic interest in the entity being evaluated for consolidation.3 However, in the instance where a controlling party in a common control group designs an entity in a way to separate power from economics for the purpose of avoiding consolidation in the separate company financial statements of a decision-maker, OCA has viewed such separation to be non-substantive.

In my example, if the manager determines that its fee is not a variable interest the amendments in ASU 2015-2 are not intended to subject the manager to potential consolidation of the entity. In other words, a decision-maker would not be required to consolidate through application of the related party tiebreakers once it determines that it does not have a variable interest in the entity.

2 ASU 2015-2, Consolidation (Topic 810) – Amendments to the Consolidation Analysis, was released in February 2015 and early adoption was permitted, including in an interim period.

3 ASC 810-10-55-37D

The SEC staff speech is consistent with the references solely to direct and indirect interests in ASC paragraph 810-10-55-37D. Those references suggest that a decision maker or service provider would include the interests of related parties under common control in the evaluation of ASC subparagraph 810-10-
55-37(c) only if the decision maker holds an economic interest in the related party.

The following decision tree describes the effect of related parties’ interests in an entity when evaluating whether a fee is a variable interest in the entity.

- **Does the decision maker or service provider hold an economic interest in the related party?**
  - **Yes**
  - **Are the decision maker or service provider and the related party under common control?**
    - **No**
      - **Consider interests held by the related party on a proportionate basis**
    - **Yes**
      - **Consider interests held by the related party in their entirety**
  - **No**
    - **Is the related party an employee or employee benefit plan of the decision maker?**
      - **Yes**
        - **Examine interests held by the related party**
      - **No**
        - **Is the employee or employee benefit plan being used to circumvent the VIE consolidation requirements?**
          - **Yes**
            - **Consider interests held by the related party on a proportionate basis**
          - **No**
            - **Exclude any interests held by the related party**

1 If a related party under common control with the decision maker or service provider is being used to separate power from economics to avoid consolidation in the decision maker’s separate company financial statements, interests held by the related party under common control are considered in their entirety regardless of whether the decision maker holds an economic interest in the related party under common control.

We believe the determination of whether a related party under common control with the decision maker or service provider is being used to separate power from economics...
from economics to avoid consolidation in the decision maker’s separate company financial statements will often require significant judgment based on the specific facts and circumstances. When the related party’s investment is not held to avoid consolidation in the decision maker’s separate company financial statements, we generally expect that the related party’s investment will not be necessary for the decision maker to market investments in the entity to third-party investors or continue in its role as the decision maker.

**Question 3.5.20.2: Evaluating Whether Entities Are Under Common Control**

How should a reporting enterprise determine whether it is under common control with a related party?

**Interpretive Response:** As noted in paragraph BC69 of ASU 2015-02, current U.S. GAAP uses the term common control in multiple contexts and the term is not defined in the Master Glossary. For purposes of evaluating the VIE related party requirements, the FASB’s intent was for the term to include subsidiaries controlled (directly or indirectly) by a common parent, or a subsidiary and its parent. Although a consensus was not reached on EITF Issue No. 02-5, *Definition of “Common Control” in Relation to FASB Statement No. 141*, it provides relevant guidance a reporting enterprise should consider in evaluating whether it is under common control with other related parties in addition to the relationships identified in paragraph BC69 of ASU 2015-02. The SEC staff indicated in EITF 02-5 that common control also exists among separate entities when:

(a) Immediate family members collectively hold a controlling financial interest in each entity (with no evidence that those family members will exercise their decision-making rights 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 require careful consideration regarding the substance of the ownership and decision-making relationships.

(b) A group of shareholders holds a controlling financial interest in each entity, and contemporaneous written evidence of an agreement to exercise their decision-making rights in concert exists.
Example 3.5.20.1: Common Control – Onshore and Offshore Funds

Three unrelated shareholders form Onshore Fund A and Offshore Fund B and each holds 18% of the voting interests in each fund (as a group the three shareholders hold 54% of the voting interests in each fund). The remaining 46% of the voting interests in Fund A and Fund B are widely dispersed among unrelated parties. The three shareholders have not entered into an agreement to vote in concert.

Because there is no agreement for the three shareholders to vote in concert, the funds would not be considered entities under common control.

Example 3.5.20.2: Common Control – Master-Feeder Structure

Onshore Fund A and Offshore Fund B each own 50% of Master Fund C. For tax purposes, U.S. investors invest in Onshore Fund A while foreign investors invest in Offshore Fund B. There are no other investors in Fund C. Fund C was formed to invest in a portfolio of asset-backed securities. Entity A is the general partner of Onshore Fund A, Offshore Fund B, and Fund C and receives fees and a carried interest from each fund that meet the conditions to be considered at-market and commensurate with the services it is providing (i.e., they meet the conditions in ASC subparagraphs 810-10-55-37(a) and 55-37(d)). Entity A holds a 5% interest in Onshore Fund A and Offshore Fund B.
In this example, Entity A’s fee would not be considered a variable interest in either Onshore Fund A or Offshore Fund B because the condition in ASC subparagraph 810-10-55-37(c) also is met (i.e., Entity A’s 5% interest in each fund would not be considered significant under that paragraph). Consequently, Entity A would not be the primary beneficiary of Onshore Fund A or Offshore Fund B. However, Entity A would need to evaluate whether its fee represents a variable interest in Fund C.

If Onshore Fund A and Offshore Fund B are considered under common control with Entity A, then Entity A would include a 100% interest in Fund C in evaluating whether its fee from Fund C is a variable interest in Fund C. In that instance, Entity A’s fee would be a variable interest in Fund C and Entity A would be the primary beneficiary of Fund C.

If Onshore Fund A and Offshore Fund B are not under common control with Entity A, then Entity A would include only an indirect 5% interest in Fund C in evaluating whether its fee from Fund C is a variable interest in Fund C. In that instance, Entity A’s fee would not be considered a variable interest in Fund C and Entity A would not be the primary beneficiary of Fund C.

Professional judgment will be needed to determine whether Onshore Fund A and Offshore Fund B are under common control with Entity A. Generally, in these types of fact patterns we believe that an entity that is not consolidated by the reporting enterprise or the reporting enterprise’s parent company for accounting purposes would not be deemed to be under common control with the reporting enterprise. In this example, if the investors in Onshore Fund A and Offshore Fund B instead invested directly in Fund C, Entity A’s fee would not be considered a variable interest in Fund C. This supports the view that Onshore Fund A and Offshore Fund B should not be considered to be under common control with Entity A. We do not believe the consolidation conclusion...
Example 3.5.20.3: Related Party Not Under Common Control with a Decision Maker

A VIE is created to hold a portfolio of asset-backed securities and is financed with multiple classes of debt and nominal equity. Entity A is the asset manager of the VIE and for its services earns base, fixed-senior and subordinated fees, and a performance-based fee whereby it receives a portion of the VIE’s profits above a targeted return. The fees are considered commensurate with the services provided and only include customary terms and conditions. Entity A does not hold any of the VIE’s debt or equity and has the power to direct the activities that most significantly impact the VIE’s economic performance. Entity A owns 10% of Entity B’s common stock, a related party that is not under common control with Entity A, and Entity B owns a 50% residual interest in the VIE.

Because Entity B is not under common control with Entity A, Entity A includes Entity B’s interest on a proportionate basis in determining whether Entity A’s fee meets the criterion in ASC subparagraph 810-10-55-37(c) to be a variable interest. Therefore, Entity A includes an indirect 5% interest in the VIE (10% of Entity B’s 50% residual interest) in determining whether its fee is a variable interest. The 5% indirect interest would not absorb more than an insignificant amount of the VIE’s expected losses or receive more than an insignificant amount of the VIE’s expected residual returns. As a result, all of the conditions in ASC paragraph 810-10-55-37 are met and Entity A’s fees would not be considered a variable interest. In addition, for reasons discussed further in Questions 6.3.30.4 and 7.3.10.1, Entity A would not be the VIE’s primary beneficiary.

Example 3.5.20.4: Related Party Under Common Control – Indirect Interest

Modifying the facts in Example 3.5.20.3, assume Entity A and Entity B are under common control. Because Entity A and Entity B are under common control and Entity A holds an economic interest in Entity B, Entity A includes Entity B’s entire 50% interest in determining whether Entity A’s fee is a variable interest. As a result, Entity A’s fees would be considered a variable interest because its related party under common control holds an interest that absorbs more than an insignificant amount of the VIE’s expected losses and expected residual returns (i.e., the condition in ASC subparagraph 810-10-55-37(c) is not met). In addition, for reasons discussed further in Questions 6.3.30.3 and 7.3.10.1, Entity A would be the VIE’s primary beneficiary.
Example 3.5.20.5: Related Party Under Common Control – No Indirect Interest

Modifying the facts in Example 3.5.20.4, assume Entity A holds no economic interest in Entity B. In this situation the evaluation depends on whether Entity B’s investment is made to separate power from economics so that Entity A can avoid consolidation of the VIE in Entity A's stand-alone financial statements. If so, Entity A would include Entity B’s entire 50% interest in determining whether Entity A’s fee is a variable interest. As a result, Entity A’s fee would be considered a variable interest. If not, Entity A would exclude Entity B’s interest in the VIE in determining whether Entity A’s fee is a variable interest and Entity A’s fee would not be considered a variable interest.

If Entity A’s fee is considered a variable interest, for reasons discussed further in Question 7.3.10.1, Entity A would not individually meet the conditions to be the VIE’s primary beneficiary, but may be considered the primary beneficiary under the guidance for determining the primary beneficiary in a common control group (see Question 7.3.20.1). If Entity A’s fee is not considered a variable interest, for reasons discussed further in Questions 6.3.30.4 and 7.3.10.1, Entity A would not be the VIE’s primary beneficiary.

Example 3.5.20.6: Related Party Not Under Common Control – No Indirect Interest

Modifying the facts in Example 3.5.20.3, assume Entity A holds no economic interest in Entity B and Entity A is not under common control with Entity B. Because Entity A holds no economic interest in Entity B, Entity A would not include Entity B’s interest in the VIE in determining whether Entity A’s fees are a variable interest. As a result, Entity A’s fees would not be considered a variable interest. In addition, for reasons discussed further in Questions 6.3.30.4 and 7.3.10.1, Entity A would not be the VIE’s primary beneficiary.

Example 3.5.20.7: Related Party Holds an Interest in Decision Maker

Modifying the facts in Example 3.5.20.6, assume Entity B owns 10% of Entity A’s common stock. Because Entity A holds no economic interest in Entity B, Entity A would not include Entity B’s interest in the VIE in determining whether Entity A’s fees are a variable interest. As a result, Entity A’s fees would not be considered a variable interest. In addition, for reasons discussed further in Questions 6.3.30.4 and 7.3.10.1, Entity A would not be the VIE’s primary beneficiary.
**Question 3.5.20.3: Indirect Interests Held Through De Facto Agents**

When evaluating the condition in ASC subparagraph 810-10-55-37(c), does the reporting enterprise include indirect interests held through de facto agents as defined in ASC paragraph 810-10-25-43?

**Interpretive Response:** Generally yes. ASC paragraph 810-10-55-37D indicates that a reporting enterprise would consider any interest in an entity that is held by a related party, including de facto agents with two exceptions – employees and employee benefit plans – unless used in an effort to circumvent the VIE provisions. However, the de facto agent’s interest would only be included if the reporting enterprise held an economic interest in the de facto agent. Assume, for example, that the reporting enterprise and another party are de facto agents due to transferability restrictions and the reporting enterprise has no other interest in the de facto agent. The de facto agent’s interest would not be considered by the reporting enterprise when evaluating the condition in ASC subparagraph 810-10-55-37(c).

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**Question 3.5.20.4: Consideration of Interests Held by Employee Benefit Plans of the Reporting Enterprise in Evaluating Whether Fees Are Variable Interests**

Are employee benefit plans sponsored by the reporting enterprise considered related parties when evaluating whether the fees paid to a decision maker or service provider are a variable interest?

**Interpretive Response:** ASC subparagraph 810-10-55-37D(a) states that an employee benefit plan of the decision maker or service provider (and its other related parties), is not considered a related party unless the plan is used in an effort to circumvent the provisions of ASC Subtopic 810-10. As such, variable interests held by an enterprise’s employee benefit plan (defined benefit or defined contribution plan) generally would not be considered together with the variable interests of the reporting enterprise when evaluating whether the fees paid to a decision maker or service provider represent a variable interest.

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**3.5.30. Reconsideration Requirements**

**Question 3.5.30.1: Reconsideration Requirements under ASC Paragraph 810-10-55-37**

When is an enterprise required to reconsider its analysis of whether fees are a variable interest under ASC paragraph 810-10-55-37?

**Interpretive Response:** The FASB indicated that if an enterprise determines that its fee meets the conditions in ASC paragraph 810-10-55-37, the enterprise is considered to be acting in a fiduciary capacity. The determination
of whether an entity is a VIE is based on the design of the entity and the reconsideration of whether an entity is a VIE is based on the occurrence of events that indicate there may have been a change in the entity’s design. Therefore, we believe that the determination of whether an enterprise is acting in a fiduciary capacity also should be a design-based analysis. A requirement for an ongoing assessment of ASC paragraph 810-10-55-37 that is not based on design would be inconsistent with the framework for evaluating and reconsidering whether an entity is a VIE.

All relevant facts and circumstances should be considered when evaluating whether there has been a change in the design of an entity. The VIE reconsideration events in ASC paragraph 810-10-35-4 would also require a reconsideration of whether fees are a variable interest under ASC paragraph 810-10-55-37, but those events should not necessarily be considered all-inclusive for that purpose. Changes in general market conditions, in isolation, presumptively would not result in a change in design. For example, if an enterprise initially concludes that its fee is not a variable interest under the provisions of ASC paragraph 810-10-55-37, changes in general market conditions and what is considered customary compensation for the services during the term of the arrangement would not cause the fee to become a variable interest. However, if the enterprise changes or renegotiates the terms of the fee arrangement, it would need to reevaluate its analysis of whether the fees are a variable interest under ASC subparagraphs 810-10-55-37(a) and 55-37(d).

Additionally, if the enterprise or its related parties purchase additional interests in the entity or dispose of interests in an entity, the enterprise should reevaluate its analysis of whether the fees are a variable interest under ASC subparagraph 810-10-55-37(c) even if the purchase or disposition is not considered to be a redesign of the entity under ASC paragraph 810-10-35-4. See also Question 3.5.10.2 about a general partner carried interest or promote.
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4.1. OVERVIEW

4.1.10.10. If an enterprise has a variable interest in an entity (see Section 3, Variable Interests) that falls within the scope of the VIE Subsections ofASC Subtopic 810-10, Consolidation - Overall (see Section 2, Scope), it must determine whether that entity is considered a variable interest entity (VIE) or a voting interest entity. If the entity meets the definition of a VIE, the enterprise should evaluate whether to consolidate the entity under the VIE consolidation requirements of ASC Subtopic 810-10 (see Section 6, Primary Beneficiary Determination and Reconsideration). If the entity is not a VIE (i.e., it is a voting interest entity), the enterprise should evaluate whether to consolidate the entity under the ASC Subtopic 810-10 guidance applicable to voting interest entities.

4.1.10.20. Whether an entity is a VIE under the requirements of ASC paragraph 810-10-15-14 depends on the amount and characteristics of its equity. If any one of the conditions in ASC paragraph 810-10-15-14 is met, the entity is a VIE.

Excerpts from ASC Subtopic 810-10

05-3 Throughout this Subtopic, any reference to a limited partnership includes limited partnerships and similar legal entities. A similar legal entity is an entity (such as a limited liability company) that has governing provisions that are the functional equivalent of a limited partnership. In such entities, a managing member is the functional equivalent of a general partner, and a nonmanaging member is the functional equivalent of a limited partner.
A legal entity shall be subject to consolidation under the guidance in the Variable Interest Entities Subsections if, by design, any of the following conditions exist. (The phrase by design refers to legal entities that meet the conditions in this paragraph because of the way they are structured. For example, a legal entity under the control of its equity investors that originally was not a VIE does not become one because of operating losses. The design of the legal entity is important in the application of these provisions.)

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

(1) Includes only equity investments in the legal entity that participate significantly in profits and losses even if those investments do not carry voting rights

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

(3) Does not include amounts provided to the equity investor directly or indirectly by the legal entity or by other parties involved with the legal entity (for example, by fees, charitable contributions, or other payments), unless the provider is a parent, subsidiary, or affiliate of the investor that is required to be included in the same set of consolidated financial statements as the investor

(4) Does not include amounts financed for the equity investor (for example, by loans or guarantees of loans) directly by the legal entity or by other parties involved with the legal entity, unless that party is a parent, subsidiary, or affiliate of the investor that is required to be included in the same set of consolidated financial statements as the investor.

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

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

(1) The power, through voting rights or similar rights, to direct the activities of a legal entity that most significantly impact the entity’s economic performance.

   i. For legal entities other than limited partnerships, investors lack that power through voting rights or similar rights if no owners hold voting rights or similar rights (such as those of a
common shareholder in a corporation). Legal entities that are not controlled by the holder of a majority voting interest because of noncontrolling shareholder veto rights (participating rights) as discussed in paragraphs 810-10-25-2 through 25-14 are not VIEs if the holders of the equity investment at risk as a group have the power to control the entity and the equity investment meets the other requirements of the Variable Interest Entities Subsections.

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

ii. For limited partnerships, partners lack that power if neither (01) nor (02) below exists. The guidance in this subparagraph does not apply to entities in industries (see paragraphs 910-810-45-1 and 932-810-45-1) in which it is appropriate for a general partner to use the pro rata method of consolidation for its investment in a limited partnership (see paragraph 810-10-45-14).

01. A simple majority or lower threshold of limited partners (including a single limited partner) with equity at risk is able to exercise substantive kick-out rights (according to their voting interest entity definition) through voting interests over the general partner(s).

A. For purposes of evaluating the threshold in (01) above, a general partner’s kick-out rights held through voting interests shall not be included. Kick-out rights through voting interests held by entities under common control with the general partner or other
parties acting on behalf of the general partner also shall not be included.

02. Limited partners with equity at risk are able to exercise substantive participating rights (according to their voting interest entity definition) over the general partner(s).

03. For purposes of (01) and (02) above, evaluation of the substantiveness of participating rights and kick-out rights shall be based on the guidance included in paragraphs 810-10-25-2 through 25-14C.

(2) The obligation to absorb the expected losses of the legal entity. The investor or investors do not have that obligation if they are directly or indirectly protected from the expected losses or are guaranteed a return by the legal entity itself or by other parties involved with the legal entity. See paragraphs 810-10-25-55 through 25-56 and Example 1 (see paragraph 810-10-55-42) for a discussion of expected losses.

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

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

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

(1) The voting rights of some investors are not proportional to their obligations to absorb the expected losses of the legal entity, their rights to receive the expected residual returns of the legal entity, or both.

(2) Substantially all of the legal entity’s activities (for example, providing financing or buying assets) either involve or are conducted on behalf of an investor that has disproportionately few voting rights. This provision is necessary to prevent a primary beneficiary from avoiding consolidation of a VIE by organizing the legal entity with nonsubstantive voting interests. Activities that involve or are conducted on behalf of the related parties of an investor with disproportionately few voting rights
shall be treated as if they involve or are conducted on behalf of that investor. The term related parties in this paragraph refers to all parties identified in paragraph 810-10-25-43, except for de facto agents under paragraph 810-10-25-43(d).

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

20 Glossary

Decision Maker

An entity or entities with the power to direct the activities of another legal entity that most significantly impact the legal entity’s economic performance according to the provisions of the Variable Interest Entities Subsections of Subtopic 810-10.

Decision Maker Authority

The power to direct the activities of a legal entity that most significantly impact the entity’s economic performance according to the provisions of the Variable Interest Entities Subsections of Subtopic 810-10.

Kick-Out Rights (VIE Definition)

The ability to remove the entity with the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance or to dissolve (liquidate) the VIE without cause.

Kick-Out Rights (Voting Interest Entity Definition)

The rights underlying the limited partner’s or partners’ ability to dissolve (liquidate) the limited partnership or otherwise remove the general partners without cause.

Participating Rights (VIE Definition)

The ability to block or participate in the actions through which an entity exercises the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance. Participating rights do not require the holders of such rights to have the ability to initiate actions.

Participating Rights (Voting Interest Entity Definition)

Participating rights allow the limited partners or noncontrolling shareholders to block or participate in certain significant financial and operating decisions of the limited partnership or corporation that are made in the ordinary course of business. Participating rights do not require the holders of such rights to have the ability to initiate actions.
Protective Rights (VIE Definition)

Rights designed to protect the interests of the party holding those rights without giving that party a controlling financial interest in the entity to which they relate. For example, they include any of the following:

(a) Approval or veto rights granted to other parties that do not affect the activities that most significantly impact the entity’s economic performance. Protective rights often apply to fundamental changes in the activities of an entity or apply only in exceptional circumstances. Examples include both of the following:

1. A lender might have rights that protect the lender from the risk that the entity will change its activities to the detriment of the lender, such as selling important assets or undertaking activities that change the credit risk of the entity.

2. Other interests might have the right to approve a capital expenditure greater than a particular amount or the right to approve the issuance of equity or debt instruments.

(b) The ability to remove the reporting entity that has a controlling financial interest in the entity in circumstances such as bankruptcy or on breach of contract by that reporting entity.

(c) Limitations on the operating activities of an entity. For example, a franchise agreement for which the entity is the franchisee might restrict certain activities of the entity but may not give the franchisor a controlling financial interest in the franchisee. Such rights may only protect the brand of the franchisor.

Protective Rights (Voting Interest Entity Definition)

Rights that are only protective in nature and that do not allow the limited partners or noncontrolling shareholders to participate in significant financial and operating decisions of the limited partnership or corporation that are made in the ordinary course of business.

4.1.10.30. Although the condition that addresses the amount of an entity’s equity is the first condition in ASC paragraph 810-10-15-14, it is usually more efficient to evaluate whether the characteristics of an entity’s equity cause the entity to be a VIE before evaluating whether the amount of its equity causes the entity to be a VIE. However, the guidance in this Section is organized using the same order as ASC paragraph 810-10-15-14, as depicted in the following decision tree.
Does the entity meet the characteristics of a VIE?

- Is the total equity investment at-risk sufficient for the entity to finance its activities without additional support provided by any parties, including equity holders? 810-10-15-14(a)
  - Yes
  - No

- Do the equity-at-risk investors as a group have the power through voting rights or similar rights to direct the activities that most significantly impact the entity's economic performance?
  - Yes
  - No

For legal entities other than LPs, do the equity-at-risk investors have power through rights similar to those of a shareholder in a corporation? 810-10-15-14(b)(13))
  - Yes
  - No

For LPs and similar entities, do the limited partners have substantive kick-out rights or participating rights over the general partner? 810-10-15-14(b)(13)(ii)
  - Yes
  - No

- Do the equity-at-risk investors as a group have the obligation to absorb the entity's expected losses? 810-10-15-14(b)(ii)
  - Yes
  - No

- Do the equity-at-risk investors as a group have the right to receive the entity's expected residual returns? 810-10-15-14(b)(iii)
  - Yes
  - No

- Do substantially all of the entity's activities involve, or are they conducted on behalf of, an investor with disproportionately few voting rights? 810-10-15-14(c)
  - Yes
  - No

The entity is a VIE; evaluate whether the reporting enterprise is the Primary Beneficiary – see Section 6

The entity is not a VIE – analyze under Voting Model

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1 The analysis of whether an entity is a VIE under ASC 810-10-15-15(b)(1) is different for limited partnerships (including similar entities) and corporations. Consequently, the determination of whether an entity is similar to a limited partnership is necessary for that purpose.

2 The guidance in ASC 810-10-15-15(b)(1)(i) does not apply to entities in industries in which it is appropriate for a general partner to use the pro rata method of consolidation for its investment in a limited partnership.

3 Activities that involve or are conducted on behalf of the related parties of an investor with disproportionately few voting rights are treated as if they involve or are conducted on behalf of that investor. The term related parties includes de facto agents as defined in ASC 810-10-25-43, except for ASC 810-1-25-43(d).

4 Disproportionate voting rights exist when an investor's share of an entity's voting rights is not equal to the investor's obligation to absorb the entity's expected losses or right to receive the entity's expected residual returns.
4.2. EQUITY INVESTMENT AT RISK

4.2.10. Steps for Determining Equity Investment At Risk

4.2.10.10. The first step an enterprise must perform to evaluate the characteristics and amount of an entity’s equity investment is to identify those investments in the entity that are equity under U.S. GAAP. The enterprise must then determine which of those investments are considered at risk under the provisions of ASC subparagraphs 810-10-15-14(a)(1)-(4). After the at-risk equity investments have been identified, the enterprise will then assess the amount and characteristics of the at-risk equity under the requirements of ASC paragraph 810-10-15-14 to determine whether the entity is a VIE.

4.2.20. Equity under U.S. GAAP

4.2.20.10. Equity investments for purposes of VIE identification “are interests that are required to be reported as equity in that entity’s financial statements.” Simply because an interest is equity in legal form or has characteristics that are similar to equity (e.g., subordinated debt) does not mean that it would be reported as equity under U.S. GAAP. For example, mandatorily redeemable preferred stock issuances are required to be reported as a liability under ASC Topic 480, Distinguishing Liabilities from Equity, and would therefore not be considered an equity investment in evaluating whether the issuer is a VIE. U.S. GAAP equity also does not include amounts due under capital calls or other subscription arrangements (i.e., unfunded amounts). However, preferred stock classified as temporary equity in the entity’s financial statements under ASC Section 480-10-S99 (SEC Accounting Series Release No. 268, Presentation in Financial Statements of ‘Redeemable Preferred Stock’), would be considered an equity investment under ASC subparagraph 810-10-15-14(a).

4.2.20.20. In certain instances, the composition of an entity’s U.S. GAAP equity may change from the date of the initial assessment to the date of a reconsideration event because of amendments to U.S. GAAP. Depending on the nature of the amendments, a voting interest entity may become a VIE if all or a portion of the entity’s equity investment at risk is no longer considered equity under U.S. GAAP. For example, a reconsideration event occurring after the effective date of ASC Topic 480 may have resulted in the reclassification of certain interests previously considered equity into liabilities in the entity’s financial statements.

Question 4.2.20.1: Commitments, Obligations, and Stock Subscriptions

Would any of the following interests potentially represent an example of an equity investment: (1) a commitment to fund equity, (2) a commitment to fund losses, (3) an obligation to absorb losses, and/or (4) a stock subscription?

Interpretive Response: No. We believe that none of these interests would be considered an equity investment at risk under U.S. GAAP. However,
depending on the entity’s design, these interests may represent a variable interest in the entity (see Section 3 for additional guidance on variable interests).

4.2.30. Requirements for Equity to Be At Risk

4.2.30.10. After identifying an entity’s U.S. GAAP equity interests, an enterprise must then determine whether those interests are considered at risk for purposes of evaluating whether an entity is a VIE. Under ASC subparagraphs 810-10-15-14(a)(1)-(4), to be considered at-risk the entity’s equity interests must:

- Participate significantly in profits and losses;
- Not have been issued in exchange for subordinated interests in other VIEs;
- Not have been provided directly or indirectly to the equity investor by the entity or parties involved with the entity (unless the provider is a parent, subsidiary, or affiliate of the investor that is required to be included in the same consolidated financial statements as the investor); and
- Not have been financed for the equity investor directly by the entity or parties involved with the entity (unless the provider is a parent, subsidiary, or affiliate of the investor that is required to be included in the same consolidated financial statements as the investor).

If there are multiple classes of equity, each equity instrument should be separately evaluated against these characteristics to determine whether it is considered equity at risk.

4.2.30.20. Common examples of equity that may be considered at risk upon further evaluation include common stock (voting and nonvoting), various types of perpetual preferred stock that significantly participate in an entity’s profits and losses, LLC member interests, general and limited partnership interests, preferred stock classified in temporary equity under SEC Accounting Series Release No. 268 (ASR 268) Presentation in Financial Statements of “Redeemable Preferred Stocks,” warrants to purchase equity interests, and certain forms of trust beneficial interests. Before concluding that an equity investment is at risk, enterprises should review its features to verify that it meets all of the conditions in ASC subparagraphs 810-10-15-14(a)(1)-(4).

Question 4.2.30.1: Evaluating Whether a Small Equity Investment Is At Risk

Is the amount or proportion of an entity’s equity that an investor holds relevant in determining whether the equity is at risk?

Interpretive Response: We believe an investor’s equity investment must be substantive for it to be considered at risk under the provisions of ASC...
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subparagraph 810-10-15-14(a). In applying those provisions, we believe the amount of an investor’s equity investment is more important than the proportion of the investor’s equity interest to the entity’s total equity interests in evaluating whether the investor has made a substantive investment. For example, in an entity with only $100 of equity, we believe an investor with an equity investment that represents 50% of the entity’s total equity would not have an at-risk equity interest because the amount of the investor’s equity interest (i.e., $50) is nominal even though the interest is significant in proportion to the entity’s total equity. Conversely, in an entity with $400 million of equity, we believe an investor with an equity investment that represents 0.25% of the entity’s total equity could be deemed to have an at-risk equity interest (if the conditions in ASC subparagraphs 810 10 15 14(a)(1)-(4) are met) even though the investor’s equity interest is not a significant portion of the entity’s total equity because the amount of the investor’s equity interest (i.e., $1,000,000) is substantive.

SIGNIFICANT PARTICIPATION IN PROFITS AND LOSSES

4.2.30.30. To be included in the amount of equity at risk, equity investments in the entity must participate significantly in the entity’s profits and losses. Based on informal conversations with the FASB staff, we understand that profits and losses should be interpreted as meaning profits and losses for U.S. GAAP reporting purposes rather than the concept of expected losses and expected residual returns under ASC Subtopic 810-10. This criterion is inclusive; if an equity investment significantly participates in profits but not losses, or vice versa, then this criterion has not been met. Because this criterion is inclusive, even if an equity investment significantly participates in the entity’s losses, a determination must also be made as to whether the equity investment at risk participates significantly in the entity’s profits. This determination should be made after considering the relative size of the investment and the potential for participation in profits. Whether a particular equity investment participates significantly in the entity’s profits and losses depends on the individual facts and circumstances including the nature of the investment (e.g., preferred or common stock), the amount of the potential losses relative to its fair value when acquired, and the nature of the entity’s assets, among other items. However, we believe there is a presumption that equity investments with a fixed rate of return do not participate significantly in the entity’s profits and losses. For example, preferred stock with a fixed rate paid to the investors probably would not be deemed to participate significantly in the entity’s profits and losses. The presumption can be overcome by demonstrating that the fixed rate of return is set at a high level in relation to the entity’s expected return on equity.
Question 4.2.30.2: Characteristics of Equity Interests That Participate Significantly in Profits and Losses

What characteristics must be present to demonstrate that an entity’s equity investment participates significantly in an entity’s profits and losses?

Interpretive Response: As discussed above, the first requirement for an equity investment to meet the criterion in ASC subparagraph 810-10-15-14(a)(1) is that it must participate significantly in an entity’s profits and losses. That is, equity interests that participate in profits but not losses (or vice versa) would not be considered equity investments at risk.

The second requirement for an equity investment to meet the criterion in ASC subparagraph 810-10-15-14(a)(1) is that its participation in profits and losses must be significant. We believe that this condition would be met if the equity interest participates in the entity’s profits and losses on a pro-rata basis based on the investor’s ownership percentage in the entity. For example, assume an investor owns 1% of an entity’s outstanding common shares and participates in the entity’s profits and losses on a pro-rata basis. While the investor’s ownership interest is small relative to the outstanding equity interests, the fact that the investor participates on a pro-rata basis indicates that its equity investment participates significantly in the entity’s profits and losses.

Professional judgment and consideration of all relevant facts and circumstances is necessary when evaluating whether participation in profits and losses is significant. This evaluation may include considering the nature of the entity’s assets and operations, magnitude of the potential profits and/or losses in relation to the initial equity investment, and the nature and terms of the equity instrument. Following are some common features in equity instruments and examples of factors to consider when evaluating whether those features would prevent the instrument from participating significantly in the entity’s profits and losses:

- **Equity Instruments with Fixed Rates of Return.** While it is typically straightforward to demonstrate that a fixed rate equity instrument, such as preferred stock, participates significantly in an entity’s losses, it may be more challenging to demonstrate that such an instrument participates significantly in an entity’s profits.

To perform this assessment, an enterprise should determine whether the fixed rate provides a debt-like or an equity-like return for the particular entity. For example, preferred stock with a 12% annual dividend rate in an entity that is expected to yield a 15% annual return on equity likely would participate significantly in the entity’s profits and losses because the return is equity-like. However, preferred stock with a 4% annual dividend rate in an entity that is expected to yield a 25% annual return on equity would represent a
debt-like return and, therefore, may not participate significantly in the entity’s profits and losses.

- **Equity Instruments with Put or Redemption Features.** In certain situations, equity interests may not subject the holder to any of the entity’s losses because the holder may have the option to put (sell) the equity interests back to the entity or to other investors at a fixed or predefined price. Enterprises must understand how the terms of the put or redemption feature would limit the investor’s potential losses when evaluating whether the instrument participates significantly in the entity’s profits and losses.

  For example, assume Entity X contributes $500 of cash and Entity Y contributes property with a fair value of $500 to form a venture (XY). Entity X and Entity Y both receive a 50% equity interest in XY in exchange for their contributions. Because there is uncertainty about the performance of the contributed assets at the inception of XY (i.e., they may appreciate or depreciate significantly due to changes in market conditions), Entity X has the right to put its equity interests to Entity Y at their initial fair value ($500). As a result of the put option, Entity X’s equity interest would not participate significantly in the entity’s losses because if losses did occur, Entity X would have no obligation to absorb any.

- **Call Options on Equity Instruments.** Equity instruments that may be called (purchased) by the entity or other equity investors may not participate significantly in the entity’s profits depending on the extent to which the equity holder is limited from receiving profits. For example, assume in the example above that Entity X received an option to purchase Entity Y’s 50% equity interest at a future date for 102% of its fair value. In this scenario, Entity Y’s equity interest likely would not participate significantly in the entity’s profits because, if profits did occur, Entity X probably would purchase Entity Y’s interest.

- **Guaranteed Returns.** If an equity investor’s returns are guaranteed by the entity or another party involved with the entity, the investor’s equity investment would typically not be considered to participate significantly in the entity’s losses.

In response to implementation issues raised in connection with the initial application of ASU 2015-02, the staff in the SEC’s Office of the Chief Accountant (OCA) discussed with members of the Securities Industry and Financial Markets Association (SIFMA) whether equity interests meet the requirements of ASC subparagraph 810-10-15-14(a) to be considered at risk when the equity represents an interest in specified assets rather than a variable interest in the entity under the provisions of ASC paragraph 810-10-25-55.
The SEC staff indicated that it would be appropriate to conclude that equity interests do not qualify to be considered equity at risk when the equity represents an interest in specified assets rather than a variable interest in the entity. For registrants that have previously concluded that equity interests qualify to be considered equity at risk when the equity represents an interest in specified assets rather than a variable interest in the entity, we understand that the SEC staff would not object to the registrant changing its prior conclusion as part of the adoption of ASU 2015-02.

Given the views expressed by the SEC staff, we believe that equity interests would not qualify to be considered equity at risk unless the equity represents a variable interest in the entity. This is likely to significantly affect the analysis of whether nonregistered series investment funds and similar entities (e.g., segregated or protected cell companies) are VIEs when the individual series investment funds are not considered to be legal entities as discussed in Questions 2.1.20.4 and 2.1.20.5. If all of the entity’s equity represents an interest in specified assets, then there would be no residual entity and no equity at risk. In that situation, we believe the entity would be a VIE because an entity that is not a VIE must have some equity at risk (see Subsection 4.2.50 and Question 4.2.50.3).

**EQUITY INTERESTS ISSUED IN EXCHANGE FOR SUBORDINATED INTERESTS IN OTHER VIEs**

4.2.30.40. Another limitation on the equity that is considered to be at risk is that it excludes equity interests issued by the entity in exchange for subordinated interests in another VIE. Conclusions about whether equity has been issued in exchange for subordinated interests in another entity often will require judgment to understand how an individual transaction fits into a larger series of transactions. The FASB included this criterion to prevent a single equity investment in one entity from capitalizing multiple entities. For example, assume that Investor uses $1,000 of cash to capitalize VIE 1 upon inception in exchange for an equity interest. Subsequent to this transaction, Investor capitalizes VIE 2 by contributing its equity interest in VIE 1. In this scenario, the equity received by Investor in VIE 2 is not considered an at-risk equity investment because it was obtained in exchange for a subordinated interest (i.e., equity) issued by another VIE.

**EQUITY INTERESTS PROVIDED BY THE ENTITY OR BY OTHERS INVOLVED WITH THE ENTITY**

4.2.30.50. Equity is not considered to be at risk under ASC subparagraph 810-10-15-14(a)(3) if the cash or other consideration used to make the investment was funded directly or indirectly, by fees, charitable contributions, or other payments made to the investor by the entity or parties that are involved with the entity, unless the provider is a parent, subsidiary, or affiliate of the investor that is required to be included in the same consolidated financial statements as the investor. Thus, the equity invested in the entity must represent the investor’s real
economic resources at risk. Equity investments provided by the entity or others involved with the entity are not considered at risk because the investors do not have *skin in the game*. To illustrate this concept, assume Enterprise X and Company Y form a venture (XY) by contributing $750 and $250, respectively, which provides them with corresponding ownership interests of 75% and 25%. XY’s profits and losses are allocated on a pro-rata basis based on the outstanding ownership interests. Further, assume that Company Y receives an up-front administrative fee of $500 from XY upon its formation. Because Company Y’s equity interest was funded by the fees paid by XY, Company Y’s equity at risk of $250 should be reduced by the $500 of fees received. Therefore, Company Y would not be considered to have any at-risk equity interests in XY.

**Question 4.2.30.3: Effect of Different Fee Arrangements on the Equity Investment At Risk**

Do all fees paid by an entity to an equity investor reduce the amount of the investor’s equity investment at risk?

**Interpretive Response:** No. While the guidance in ASC subparagraph 810-10-15-14(a)(3) appears to indicate that all fees paid by an entity to its equity investors would reduce the amount of the investor’s equity investment at risk, we believe that the terms and substance of all fee and similar arrangements should be evaluated to understand whether these arrangements are intended to provide a return of capital to the equity investors. If the fee is designed to return capital to the equity investors, we believe that amounts received through the fee arrangement would reduce the investor’s equity investment at risk.

Consider the following fee arrangements:

- **Fees paid over time in the future (at market value).** Fees to be paid for services rendered over a specified period in the future at the market rate at the time of payment typically would not reduce the investor’s equity investment at risk because the fee arrangement is not structured to return capital to the investor.

- **Fees paid over time in the future (above market value).** Fees to be paid for services rendered over a specified period in the future at a rate above the market rate at the time of payment typically would reduce the investor’s equity investment at risk. In this instance, the portion of the fee that represents the above-market component would reduce the investor’s equity investment at risk because it is designed as a mechanism to return capital. In addition, such fees would be considered a variable interest in the entity because the fees are not at market value (see paragraph 3.5.10.10).

- **Upfront and Unconditional Fees.** We believe that upfront fees paid by the entity to the equity investors (e.g., concurrent with the formation of the entity) and unconditional fees to be paid over time represent a return of capital that would reduce the investor’s equity investment at risk. If the fees will be received in the future, the
present value of the unconditional fees to be paid should be used to reduce the amount of the equity investment at risk.

- **Reimbursements.** If the equity investor receives cash or other assets from the entity to pay an unaffiliated third party for services it rendered to the entity, the equity investment at risk would not be reduced. In this scenario, the equity investor is essentially serving as a conduit through which payment is made.

- **Contingent Fees.** If the equity investor will receive fees only in certain contingent events, we believe that those fees would not reduce the amount of the equity investment at risk if the contingencies are substantive. That is, if there is a substantive risk that the contingent events will not be met. All relevant facts and circumstances should be considered when evaluating whether a contingent fee is substantive in nature.

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Example 4.2.30.1: Consideration of Fees Received by an Equity Investor from the Investee

**Background**

Entity C, a land owner and developer, forms a venture (Entity B) to construct a residential condominium. Upon formation of Entity B, Entity C and a third-party investor contribute $25,000 and $475,000, respectively, in exchange for a 5% and 95% equity ownership interest. At Entity B’s inception, Entity C is paid an upfront development fee of $10,000 and is guaranteed an additional $5,250 on the first anniversary of Entity B’s formation. Furthermore, if Entity B generates a return of more than 20% over the next three years, Entity C will receive an additional $15,000. It is only probable that Entity B will generate a return of approximately 8% over this time. Entity C will also function as the property manager upon completion of the property’s construction and receive a market-based fee of $20,000 each year.

**Evaluation**

In this example, Entity C’s equity investment at risk is $10,000 at the time Entity B is formed. This amount is calculated by subtracting the upfront fee of $10,000 and $5,000 for the present value of the fee due to Entity C on the first anniversary (present value calculation uses a 5% discount rate) from the $25,000 initially contributed. The contingent fee of $15,000 due to Entity C upon meeting certain performance goals would not reduce the equity investment at risk because the contingency is substantive. Additionally, the management fee of $20,000 per year would not affect the equity investment at risk because Entity C would be receiving a market rate for these services.
Question 4.2.30.4: Sweat Equity

Is an equity investment received by an investor in exchange for performing services (referred to as sweat equity) considered an equity investment at risk under ASC subparagraph 810-10-15-14(a)?

Interpretive Response: No. We believe that sweat equity interests would not be considered equity investments at risk because the entity is providing those interests to the investor as fees. ASC subparagraph 810-10-15-14(a)(3) excludes such interests from those considered to be at risk. Consider the following example:

Background

Entity C, a land owner, and Enterprise Y, an investor, form a venture (Entity B) to develop and operate a commercial real estate property. At the inception of Entity B, Entity C contributes land with a fair value of $5 million and Enterprise Y contributes $5 million in cash. Because neither Entity C nor Enterprise Y has property management experience, they agree to provide an equity interest in Entity B to a property manager (Company M) in exchange for ongoing property management services. Upon Entity B’s inception, each party’s equity interests and related fair values are as follows:

<table>
<thead>
<tr>
<th>Ownership Percentage</th>
<th>Fair Value</th>
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</thead>
<tbody>
<tr>
<td>Entity C</td>
<td>40%</td>
</tr>
<tr>
<td>Enterprise Y</td>
<td>40%</td>
</tr>
<tr>
<td>Company M</td>
<td>20%</td>
</tr>
</tbody>
</table>

Evaluation

In the scenario outlined above, Entity B has $8 million of equity investment at risk (comprising the equity interests held by Entity C and Enterprise Y). The $2 million equity investment held by Company M is not considered to be at risk because this interest was received in exchange for the performance of property management services (i.e., it represents sweat equity).

While this example illustrates the transfer of tangible property to an entity (e.g., cash and land) in exchange for an equity interest in an entity, we also believe that the exchange of intangible assets for an equity investment may be considered at risk if the intangible assets meet the requirements to be separately recognized as an asset apart from goodwill under ASC Topic 805, Business Combinations. We also believe that the exchange of intangible assets for an equity investment
may be considered at risk even if a private company elects the alternative not to separately recognize certain intangible assets as permitted in FASB Accounting Standards Update No. 2014-18 (ASU 2014-18), Accounting for Identifiable Intangible Assets in a Business Combination.

Example 4.2.30.2: Low-Income Housing Limited Partnership

Description of the Arrangement

A low-income housing limited partnership is formed to develop and operate a multifamily housing project. If a specified number of the housing units remain affordable for at least 15 years to tenants who earn 60% or less of the area median income, investors in the partnership are eligible for a 10-year federal income tax credit on their investment. Total capitalization of the partnership comprises mortgage debt on the property (from a single lender) and partnership interests equal to the amount of the mortgage debt.

The partnership has a single general partner (GP) with a 5% GP interest and a single limited partner (LP) with a 95% LP interest.

The LP expects to receive its investment return entirely through the income tax credits. The GP guarantees the LP that the project will be developed as required to be eligible for the income tax credits and receives a development fee at inception of the arrangement equal to 6% of the initial property value. The GP also has the right to receive the residual value of the property. Other than the guarantee arrangement and the GP’s right to the residual value of the property, all expected losses of the partnership are shared in proportion to the respective interests of the partners. In addition, the GP receives the majority of the benefit if the property is able to generate rental payments that exceed expectations. As a result, the return received by the LP is economically equivalent to the return received by an investor in investment grade debt.

Evaluation

The equity investment of the GP (5% of total partnership interests, which represent 50% of the property value) is less than the amount of the up-front fee (6% of total property value) that the GP receives. As a result, the GP’s equity is excluded from the at-risk equity group in determining whether the limited partnership is a VIE.

EQUITY INTERESTS FINANCED BY THE ENTITY OR OTHERS INVOLVED WITH THE ENTITY

4.2.30.60. Under ASC subparagraph 810-10-15-14(a)(4), equity is not considered to be at risk if the cash or other consideration used to make the investment was financed directly by the entity or other parties involved with the entity unless the provider of financing is a parent, subsidiary, or affiliate of the
investor that is required to be included in the same consolidated financial statements as the investor. Amounts financed for the equity investor include loans or guarantees of loans. Parties involved with the entity include, but are not limited to, parties that have either an explicit or implicit variable interest in the entity. This provision is very broad and appears to be similar to the guidance in ASC Subtopic 480-10, *Distinguishing Liabilities from Equity - Overall*. While this provision precludes any equity investment that was funded by parties involved with the entity from being considered at risk, we believe that financing received from parties not involved with the entity would not preclude the equity investment from being considered at risk. However, if the party providing the financing has an implicit variable interest in the entity, even if that interest arises through an arrangement entered into with parties other than the entity, the amount of the enterprise’s equity investment that is financed would not be considered to be at risk.

**Example 4.2.30.3: Financing Obtained from an Unaffiliated Entity**

**Background**

Entity C, a land owner, forms a venture (Entity B) to develop and operate a $25 million retail shopping center. At Entity B’s inception, Entity C borrows $5 million from Lender Z, an unaffiliated financial institution, and contributes this amount to Entity B in exchange for an equity interest. The terms of the loan stipulate that the debt is recourse only to Entity C’s equity interest in Entity B rather than to the general credit of Entity C. To obtain the additional financing needed for the shopping center’s construction, Entity B borrows $20 million from Lender Y. Entity B’s expected losses are $4 million.

**Evaluation**

In this example, the $5 million equity investment made by Entity C would be considered at risk because it was financed by a lender unaffiliated with the structure.

**Example 4.2.30.4: Financing Obtained from an Affiliated Entity**

**Background**

In addition to the facts in Example 4.2.30.3, assume that $2 million of Entity C’s $5 million equity investment is financed by Lender Y and the remaining $3 million is financed by Lender Z.

**Evaluation**

In this scenario, Entity B has only $3 million of equity at risk because $2 million of the equity was financed by Lender Y, which is involved with Entity B.
4.2.30.70. An investor’s equity interest in an entity may be subject to a call option, put option, or total return swap. Depending on the terms and the counterparty’s involvement with the entity (if any), these derivatives may reduce the amount of the investor’s equity investment at risk. The following table outlines different scenarios for call options, put options, and total return swaps as well as whether we believe the arrangement would cause the conditions in ASC subparagraphs 810-10-15-14(a)(1) or (4) not to be met:

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<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>Fixed-price, physically settled call option written by the equity investor on its equity interest</td>
<td>Unrelated party that has no involvement with the entity</td>
<td>Yes. The characteristics of the equity instrument are unaffected by the call option. Even though the call option may limit the equity investor’s participation in the entity’s profits, that limitation does not arise because of the terms of the equity instrument.</td>
<td>Yes. This condition would be met because the counterparty is an unrelated party that has no involvement with the entity.</td>
</tr>
<tr>
<td>Fixed-price, physically settled put option purchased by the equity investor on its equity interest</td>
<td>Unrelated party that has no involvement with the entity</td>
<td>Yes. Similar to the written call option, the characteristics of the equity instrument are unaffected by the put option. Even though the put option may limit the equity investor’s participation in the entity’s losses, that limitation does not arise because of the terms of the equity instrument.</td>
<td>Yes. This condition would be met because the counterparty is an unrelated party that has no involvement with the entity.</td>
</tr>
<tr>
<td>Net settleable total return swap entered into by the equity investor based on the total return of its equity investment</td>
<td>Unrelated party that has no involvement with the entity</td>
<td>Yes. Even though the total return swap may limit the equity investor’s participation in the entity’s profits and losses, that limitation does not arise because of the terms of the equity instrument.</td>
<td>Yes. This condition would be met because the counterparty is an unrelated party that has no involvement with the entity.</td>
</tr>
<tr>
<td>Fixed-price, physically settled call option written by the equity investor on its equity interest</td>
<td>The entity</td>
<td>No. Because the contract is entered into with the issuer of the equity and the equity is the underlying for the contract, we believe the contract terms are inseparable from the terms of the equity instrument. Because the contract is an integral part of the equity, we do not believe the condition would be met.</td>
<td>Yes, unless the call option is deep in the money. If the call option is not deep in the money when it is written, this condition would be met because the equity interest was not financed by the entity.</td>
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</tr>
<tr>
<td>Fixed-price, physically settled put option purchased by the equity investor on its equity interest</td>
<td>The entity</td>
<td>No. Because the contract is entered into with the issuer of the equity and the equity is the underlying for the contract, we believe the contract terms are inseparable from the terms of the equity instrument. Because the contract shields the equity investor from participating in the entity's losses, this condition would not be met.</td>
<td>No. This condition would not be met because a fixed-price put option is in substance the same as the investor receiving a loan to finance its equity investment or a guarantee of a loan to finance its equity investment from the entity.</td>
</tr>
<tr>
<td>Fixed-price, physically settled call option written by the equity investor on its equity interest</td>
<td>A party involved with the entity</td>
<td>Yes. The characteristics of the equity instrument are unaffected by the call option. Even though the call option may limit the equity investor’s participation in the entity’s profits, that limitation does not arise because of the terms of the equity instrument.</td>
<td>Yes, unless the call option is deep in the money. If the call option is not deep in the money when it is written, this condition would be met because the equity interest was not financed by the party involved with the entity. If the call option is deep in the money, we believe the premium received by the equity investor would be considered a form of financing received from the party that is involved with the entity and this condition would not be met.</td>
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<td>---------------------------------------------------------------</td>
</tr>
<tr>
<td>Fixed-price, physically settled put option purchased by the equity investor on its equity interest</td>
<td>A party involved with the entity</td>
<td>Yes. Similar to the written call option, the characteristics of the equity instrument are unaffected by the put option. Even though the put option may limit the equity investor’s participation in the entity’s losses, that limitation does not arise because of the terms of the equity instrument.</td>
<td>No. This condition would not be met because a fixed-price put option is in substance the same as the investor receiving a loan to finance its equity investment or a guarantee of a loan to finance its equity investment from the party involved with the entity.</td>
</tr>
<tr>
<td>Net settleable total return swap entered into by the equity investor based on the total return of its equity investment</td>
<td>A party involved with the entity</td>
<td>Yes. Even though the total return swap may limit the equity investor’s participation in the entity’s profits and losses, that limitation does not arise because of the terms of the equity instrument.</td>
<td>No. This condition would not be met because the arrangement is in substance the same as the investor receiving a loan to finance its equity investment or a guarantee of a loan to finance its equity investment from the party involved with the entity.</td>
</tr>
</tbody>
</table>

4.2.30.80. When evaluating whether an entity’s equity investment is at risk (and when identifying holders of variable interests), enterprises should assess the effects of financing arrangements, derivative positions, and other activities occurring around the entity (i.e., those activities or arrangements that the entity is not a direct party to). The need to consider activities occurring outside of the entity when applying the guidance in the VIE Subsections of ASC Subtopic 810-10 was highlighted during a speech given by Jane Poulin of the SEC staff during the 2004 AICPA National Conference on Current SEC and PCAOB Developments. While the speech references the consolidation literature addressing variable interest entities before the issuance of FASB Accounting Standards Update No. 2009-17 (ASU 2009-17), Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities (originally issued as FASB Statement No. 167, Amendments to FASB Interpretation No. 46(R) (Statement 167)), we believe that the guidance in the following excerpt is still relevant:
We have seen a number of questions about whether certain aspects of a relationship that a variable interest holder has with a variable interest entity (VIE) need to be considered when analyzing the application of [the VIE guidance in ASC Subtopic 810-10]. These aspects of a relationship are sometimes referred to as activities around the entity. It might be helpful to consider a simple example. Say a company (Investor A) made an equity investment in a potential VIE and Investor A separately made a loan with full recourse to another variable interest holder (Investor B). We have been asked whether the loan in this situation can be ignored when analyzing the application of [the VIE guidance in ASC Subtopic 810-10]. The short answer is no. First, [the VIE guidance in ASC Subtopic 810-10] specifically requires you to consider loans between investors as well as those between the entity and the enterprise in determining whether equity investments are at risk, and whether the at risk holders possess the characteristics of a controlling financial interest as defined in [ASC paragraph 810-10-15-14(b)]. It is often difficult to determine the substance of a lending relationship and its impact on a VIE analysis on its face. You need to evaluate the substance of the facts and circumstances. The presence of a loan between investors will bring into question, in this example, whether Investor B’s investment is at risk and depending on B’s ownership percentage and voting rights, will influence whether the at risk equity holders possess the characteristics of a controlling financial interest.

Other “activities around the entity” that should be considered when applying [the VIE guidance in ASC Subtopic 810-10] include equity investments between investors, puts and calls between the enterprise and other investors and non-investors, service arrangements with investors and non-investors, and derivatives such as total return swaps. There may be other activities around the entity that need to be considered which I have not specifically mentioned. These activities can impact the entire analysis under [the VIE guidance in ASC Subtopic 810-10] including the assessment of whether an entity is a VIE as well as who is the primary beneficiary.

In another situation involving activities around the entity, investors became involved with an entity because of the availability of tax credits generated from the entity’s business. Through an arrangement around the entity, the majority of the tax credits were likely to be available to one specific investor. Accordingly, the staff objected to an analysis by this investor that 1) did not include the tax credits as a component of the investor’s variable interest in the entity and 2) did not consider the impact of the tax credits and other activities around the entity on the expected loss and expected residual return analysis.

2 FIN 46R, paragraph 5(a)(4) [ASC subparagraph 810-10-15-14(a)(4)].
3 FIN 46R, paragraph 5(b) [ASC subparagraph 810-10-15-14(b)].
4.2.40. Determining Whether the Equity Investment At Risk Is Sufficient

Excerpt from ASC Subtopic 810-10

Sufficiency of Equity Investment at Risk

25-45 An equity investment at risk of less than 10 percent of the legal entity’s total assets shall not be considered sufficient to permit the legal entity to finance its activities without subordinated financial support in addition to the equity investment unless the equity investment can be demonstrated to be sufficient. The demonstration that equity is sufficient may be based on either qualitative analysis or quantitative analysis or a combination of both. Qualitative assessments, including, but not limited to, the qualitative assessments described in (a) and (b), will in some cases be conclusive in determining that the legal entity’s equity at risk is sufficient. If, after diligent effort, a reasonable conclusion about the sufficiency of the legal entity’s equity at risk cannot be reached based solely on qualitative considerations, the quantitative analyses implied by (c) shall be made. In instances in which neither a qualitative assessment nor a quantitative assessment, taken alone, is conclusive, the determination of whether the equity at risk is sufficient shall be based on a combination of qualitative and quantitative analyses.

(a) The legal entity has demonstrated that it can finance its activities without additional subordinated financial support.

(b) The legal entity has at least as much equity invested as other entities that hold only similar assets of similar quality in similar amounts and operate with no additional subordinated financial support.

(c) The amount of equity invested in the legal entity exceeds the estimate of the legal entity’s expected losses based on reasonable quantitative evidence.

25-46 Some legal entities may require an equity investment at risk greater than 10 percent of their assets to finance their activities, especially if they engage in high-risk activities, hold high-risk assets, or have exposure to risks that are not reflected in the reported amounts of the legal entities’ assets or liabilities. The presumption in the preceding paragraph does not relieve a reporting entity of its responsibility to determine whether a particular legal entity with which the reporting entity is involved needs an equity investment at risk greater than 10 percent of its assets in order to finance its activities without subordinated financial support in addition to the equity investment.

25-47 The design of the legal entity (for example, its capital structure) and the apparent intentions of the parties that created the legal entity are important qualitative considerations, as are ratings of its outstanding debt (if any), the interest rates, and other terms of its financing arrangements. Often, no single factor will be conclusive and the determination will be based on the preponderance of evidence. For example, if a legal entity does not have a
limited life and tightly constrained activities, if there are no unusual arrangements that appear designed to provide subordinated financial support, if its equity interests do not appear designed to require other subordinated financial support, and if the entity has been able to obtain commercial financing arrangements on customary terms, the equity would be expected to be sufficient. In contrast, if a legal entity has a very small equity investment relative to other entities with similar activities and has outstanding subordinated debt that obviously is effectively a replacement for an additional equity investment, the equity would not be expected to be sufficient.

4.2.40.10. The first characteristic that defines a VIE is that the amount of its equity investment at risk is not sufficient in relation to the economic risks inherent in its activities (i.e., the entity’s assets, operating liabilities (regardless of whether they are recognized under U.S. GAAP), and operations). Those economic risks are referred to as the entity’s expected losses, which is the benchmark used in the VIE Subsections of ASC Subtopic 810-10 in determining the sufficiency of equity.

4.2.40.20. ASC paragraphs 810-10-25-45 through 25-47 state that an entity’s equity investment at risk is deemed to be sufficient if the entity can demonstrate that: (1) it can finance its activities without additional subordinated financial support, (2) it has at least as much equity invested as other entities that hold only similar assets of similar quality in similar amounts and operate with no additional subordinated financial support, or (3) the amount of its equity exceeds the estimate of its expected losses based on reasonable quantitative evidence. The first and second methods represent the FASB’s preferred methods of demonstrating the sufficiency of the entity’s equity investment. As such, quantitative assessments should generally be performed only if the qualitative analysis provides inconclusive results.

4.2.40.30. The FASB acknowledged that applying qualitative considerations may be difficult, especially identifying comparable entities, because finding comparably sized entities that have similar assets, liabilities, and other interests that have financed their operations without additional subordinated financial support, may be a challenge. As a result, the Board decided to permit a comparison of an entity’s equity investment with the entity’s expected losses. Expected losses are derived from an estimate of the entity’s expected cash flows using the methodology described in FASB Concepts Statement No. 7, Using Cash Flow Information and Present Value in Accounting Measurements.

4.2.40.40. In addition to the qualitative considerations outlined in ASC paragraph 810-10-25-45, enterprises should carefully assess all other relevant facts and circumstances because a conclusion about the sufficiency of an entity’s equity is based on the preponderance of the evidence obtained. Additional qualitative factors that may assist an enterprise in making this determination include, but are not limited to the:

- Design of the entity, including its capital structure (e.g., terms, ratings, maturities, and amounts of its instruments, etc.);
• Nature of its operations (e.g., source of cash flows, key products and services provided, areas of operation, etc.);
• Nature of its assets (e.g., credit quality, asset types, liquidity, etc.); and
• Apparent intentions of the parties that created the entity.

4.2.40.50. Objectively demonstrating that an entity can finance its activities may be difficult if the entity lacks a relatively simple capital structure. For example, an entity capitalized with multiple classes of debt, having different priorities, may be unable to demonstrate the ability to finance its activities without additional financial support because it could be ambiguous whether the equity investment at risk is sufficient to absorb the entity’s expected losses.

4.2.40.60. Although quantitative analyses may seem to provide a more precise and less subjective means of determining the sufficiency of an entity’s equity at risk, that appearance is deceptive because the lack of objective evidence on which to base the necessary estimates and assumptions results in imprecision and subjectivity. Consequently, the FASB indicated that a reasoned professional judgment about whether an entity has sufficient equity to finance its own activities without additional subordinated financial support, considering all facts and circumstances, often is as good as, or even better than, mathematical computations based on estimates and assumptions that accountants have historically not been required to make.

4.2.40.70. When performing a quantitative assessment to determine whether the entity’s equity at risk is sufficient to finance its activities without additional subordinated financial support, we believe that the total fair value of the entity’s equity at risk under ASC Topic 820, *Fair Value Measurement*, should be compared with the entity’s expected losses. While the fair value and carrying amounts may be the same on the date of the entity’s inception, the fair value typically will differ from the carrying amount on subsequent dates. Using the fair value, rather than the GAAP carrying amount, of the equity at risk also is consistent with the requirement to compute expected losses using the expected cash flow methodology in Concepts Statement No. 7; that methodology embodies a fair value notion.

4.2.40.80. ASC paragraph 810-10-25-45 establishes a presumption that an entity’s equity investment must be at least 10% of its total assets to support a conclusion that the entity’s equity is sufficient. If an entity’s equity is less than 10% of its total assets, it is assumed that the equity investment is insufficient to finance the entity’s activities without subordinated financial support. However, the 10% presumption is not a safe harbor and the factors that overcome the 10% presumption must be considered to support a conclusion that equity of greater than 10% is sufficient. Consequently, the 10% presumption has little effect on evaluating whether an entity’s equity is sufficient.
**Question 4.2.40.1: Non-Equity Interests Held by Holders of an Entity’s Equity At Risk**

Would non-equity interests held by the holders of an entity’s equity investment at risk, such as subordinated debt, be considered when evaluating whether the entity’s equity investment at risk is sufficient?

**Interpretive Response:** No. ASC subparagraph 810-10-15-14(a) states that an entity’s equity investments at risk "are required to be reported as equity in that entity’s financial statements." Accordingly, we believe that other interests that are not equity under U.S. GAAP should be excluded from consideration in evaluating the sufficiency of an entity’s at-risk equity.

For example, assume that an entity is capitalized with $10 of equity at risk and $4 of subordinated debt (both interests are held by one investor). If the entity’s expected losses were less than $10, the equity would be considered sufficient to permit it to operate without additional subordinated financial support from other parties. However, if the entity’s expected losses exceeded $10 but did not exceed $14, then the equity investment at risk would not be considered sufficient even though an equity investor (through its subordinated debt interest) still would absorb any incremental expected losses (i.e., those in excess of the $10 equity investment at risk). When applying the guidance in ASC subparagraph 810-10-15-14(a), understanding the classification of the instrument as a liability or equity under U.S. GAAP is paramount. That is, even though an equity investor may absorb incremental expected losses through its other interests, those interests must be reported as equity under U.S. GAAP to be considered part of the entity’s at-risk equity investment.

**Question 4.2.40.2: Entities That Obtain Additional Subordinated Financial Support**

How should subordinated debt (that is not reported as equity under U.S. GAAP) issued by an entity be evaluated under ASC subparagraph 810-10-15-14(a) when all of the entity’s creditors (both senior and subordinated) have recourse to only the entity or to specified assets of the entity, or both (i.e., there are no guarantees provided to the lenders)?

**Interpretive Response:** The issuance of subordinated debt by an entity is an indicator that the equity at risk may not be sufficient; however, all considerations in ASC paragraph 810-10-25-45 must be evaluated before reaching a conclusion. Because subordinated debt represents additional subordinated financial support, the entity would not meet the condition in ASC subparagraph 810-10-25-45(a). However, if the entity can demonstrate that it meets either the condition in ASC subparagraph 810-10-25-45(b) or the condition in ASC subparagraph 810-10-25-45(c), the issuance of subordinated debt would not mean that the entity’s equity is insufficient to finance its activities. Factors to consider in evaluating whether subordinated debt issued...
by an entity indicates that the entity’s equity is insufficient to permit the entity to finance its activities include, but are not limited to, the yield on the subordinated debt and the nature and quality of the entity’s assets.

**Question 4.2.40.3: Consideration of Both Qualitative and Quantitative Analyses**

Would the results of a quantitative analysis indicating that an entity’s equity investment at risk is sufficient take precedence over the results of a qualitative analysis that is either inconclusive or indicates that equity is insufficient?

**Interpretive Response:** Generally, yes. While ASC paragraph 810-10-25-45 states that an enterprise could perform a "…a qualitative analysis or quantitative analysis or a combination of both" to demonstrate that equity is sufficient, it indicates that a quantitative assessment should only be performed if the qualitative analysis is inconclusive. The FASB emphasized the use of the qualitative approach because while quantitative analyses may seem to provide a more precise and less subjective means of determining the sufficiency of an entity’s equity at risk, those analyses may inherently result in more subjective, less precise results due to the lack of objective evidence on which to base the necessary estimates and assumptions. In some situations, an evaluation of the sufficiency of an entity’s equity investment at risk that is based on both qualitative and quantitative analyses considering all relevant facts and circumstances may provide better evidence than relying solely on quantitative analyses.

For example, assume that Company X forms Enterprise Y by contributing $5,000 of cash in exchange for 100% of its equity, all of which is considered at risk. Company X performs a series of qualitative analyses to ascertain whether Enterprise Y’s equity investment at risk is sufficient. However, the results of these qualitative analyses are inconclusive. Company X then performs a quantitative analysis to compare the amount of Enterprise Y’s total equity investment at risk to an estimate of Enterprise Y’s expected losses. While Enterprise Y’s equity investment at risk ($5,000) exceeds its expected losses ($4,950), slightly changing some of the estimates or assumptions in the quantitative analysis could alter the overall result. In this situation, Company X should consider the results obtained from both the qualitative and quantitative assessments in reaching a conclusion about the sufficiency of Enterprise Y’s equity investment at risk.
Question 4.2.40.4: Expected Losses Associated with Specified Assets and Silos

How should expected losses associated with specified assets and silos be considered when evaluating whether an entity’s equity at risk is sufficient under ASC subparagraph 810-10-15-14(a)?

Interpretive Response: As discussed beginning at paragraph 3.4.10.10, expected losses associated with specified assets should only be considered in determining an entity’s expected losses if the specified assets comprise more than 50% of the fair value of the entity’s total assets. Because losses absorbed by holders of the interest(s) in specified assets are not attributable to the holders of the entity’s equity investment at risk if the 50% threshold is not met, expected losses associated with those interests should be removed from the entity’s expected loss calculation in evaluating the sufficiency of the entity’s equity at risk. Furthermore, expected losses of the entity should not include expected losses related to silos.

In response to implementation issues raised in connection with the initial application of ASU 2015-02, the staff in the SEC’s Office of the Chief Accountant (OCA) discussed with members of SIFMA whether equity interests meet the requirements of ASC subparagraph 810-10-15-14(a) to be considered at risk when the equity represents an interest in specified assets rather than a variable interest in the entity under the provisions of ASC paragraph 810-10-25-55.

The SEC staff indicated that it would be appropriate to conclude that equity interests do not qualify to be considered equity at risk when the equity represents an interest in specified assets rather than a variable interest in the entity. For registrants that have previously concluded that equity interests qualify to be considered equity at risk when the equity represents an interest in specified assets rather than a variable interest in the entity, we understand that the SEC staff would not object to the registrant changing its prior conclusion as part of the adoption of ASU 2015-02.

Given the views expressed by the SEC staff, we believe that equity interests would not qualify to be considered equity at risk unless the equity represents a variable interest in the entity. This is likely to significantly affect the analysis of whether nonregistered series investment funds and similar entities (e.g., segregated or protected cell companies) are VIEs when the individual series investment funds are not considered to be legal entities as discussed in Questions 2.1.20.4 and 2.1.20.5. If all of the entity’s equity represents an interest in specified assets, then there would be no residual entity and no equity at risk. In that situation, we believe the entity would be a VIE because an entity that is not a VIE must have some equity at risk.
Example 4.2.40.1: Amount of Equity Compared with Expected Losses

A research and development (R&D) venture that does not qualify for the business scope exception in ASC subparagraph 810-10-15-17(d) is formed to develop a new medication. The venture is capitalized with one party contributing cash of $2,500 and the other party contributing in-process R&D with a fair value of $2,500 (and a carrying value of zero). At inception, the venture has no debt. Assume that the venture has expected losses of $3,000. The U.S. GAAP basis of the venture’s equity is only $2,500 (the value of its recognized asset – cash). However, the venture has no debt, and the fair value of the equity at risk is $5,000, which is sufficient to absorb the venture’s expected losses. If none of the conditions in ASC subparagraphs 810-10-15-14(b) or 15-14(c) exist with respect to the venture, it would not be considered a VIE.

Question 4.2.40.5: Consideration of Other Equity Accounts

In determining the amount of the equity investment at risk, are the amounts reported in other comprehensive income considered?

**Interpretive Response:** As stated above, the total fair value of the entity’s equity at risk under ASC Topic 820 should be compared with the entity’s expected losses to determine whether the entity’s equity at risk is sufficient. Items reported in other comprehensive income should already be included in the fair value of the equity interests and therefore would be considered in determining the fair value of the equity investment at risk, regardless of whether they are favorable or unfavorable. Caution should be exercised not to double count the components of other comprehensive income in the computation.

Question 4.2.40.6: Compliance with Regulatory Capital Requirements

If a bank or regulated financial institution exceeds the minimum required regulatory capital requirements, can it conclude that it has sufficient equity under ASC subparagraph 810-10-15-14(a)?

**Interpretive Response:** We do not believe that a bank or regulated financial institution’s compliance with minimum regulatory capital levels, in and of itself, provides determinative evidence that it has sufficient equity under ASC subparagraph 810-10-15-14(a). However, we believe that all relevant facts and circumstances should be considered when evaluating the sufficiency of an entity’s equity investment at risk. This may include, if applicable, an assessment of the capital levels of the bank or regulated financial institution at the time of the evaluation. Certain regulated financial institutions may operate at regulatory capital levels below 10% of their assets. We understand that such
institutions are one of the reasons that the FASB did not mandate that equity exceed 10% of assets in all cases to conclude that the equity investment is sufficient.

Example 4.2.40.2: Evaluating the Sufficiency of an Entity’s Equity Investment at Risk under ASC Paragraph 810-10-25-45

Background

BW Enterprises, a small-scale waste management company, provides garbage removal services for restaurants and commercial office properties in the Northeast. It should be noted that BW Enterprises does not qualify for any of the scope exceptions in the VIE Subsections of ASC Subtopic 810-10.

At the date of its inception, the balance sheet of BW Enterprises consisted of:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total assets</td>
<td>$15.0 million</td>
</tr>
<tr>
<td>Nonrecourse loan</td>
<td>9.0 million</td>
</tr>
<tr>
<td>Unsecured loan</td>
<td>2.0 million</td>
</tr>
<tr>
<td>Other operating liabilities</td>
<td>2.0 million</td>
</tr>
<tr>
<td>Equity</td>
<td>2.0 million</td>
</tr>
</tbody>
</table>

The nonrecourse loan has a 5% coupon rate, a seven-year term and is secured only by garbage trucks and dumpsters (i.e., the lender has no recourse to the equity investors or other assets of BW Enterprises). The unsecured loan pays a 9% annual coupon, has a nine-year term, and is guaranteed by the individual equity investors. Additionally, all of the equity is considered at risk.

Evaluation

BW Enterprises cannot finance its activities without additional subordinated financial support under ASC subparagraph 810-10-25-45(a) because the unsecured loan has recourse to the individual equity investors (i.e., due to the guarantee). Assuming that the equity of BW Enterprises is not sufficient under ASC subparagraph 810-10-25-45(b) (i.e., that it does not have at least as much equity invested as other similar entities), the quantitative analysis described in ASC subparagraph 810-10-25-45(c) will need to be performed to determine whether BW Enterprises’ equity at risk is sufficient. When performing the quantitative assessment, it should be noted that while the ratio of the at-risk equity to total assets (13%) exceeds the 10% threshold described in ASC paragraph 810-10-25-45, this factor is not determinative and, therefore, does not eliminate the need to compare BW Enterprises’ equity at risk to its expected losses.
**Scenario 1**

Assume that the unsecured loan was not guaranteed by the equity investors, has a 12% annual coupon and 15-year term, and the holder is entitled to 25% of net operating income above a predefined amount.

**Evaluation**

In this scenario, an expected loss calculation as described in ASC paragraph 810-10-25-45 is necessary. The high coupon on the unsecured debt appears to provide an equity-like return to the lender, indicating that the equity investment at risk may be insufficient. The 12% annual interest rate and other equity participation features were required to compensate the lender for the lack of a guarantee by the equity investors and indicate that BW Enterprises’ equity at risk may not be sufficient.

**Scenario 2**

Assume that the expected loss calculation in Scenario 1 indicated that BW Enterprises’ expected losses are $1.5 million, but that certain expected loss scenarios exceeded the $2.0 million of equity at risk.

**Evaluation**

Because the expected losses are less than BW Enterprises’ equity investment at risk, the equity investment at risk would be deemed sufficient under ASC paragraph 810-10-25-45 even though a loss in excess of the equity at risk investment may be incurred in certain scenarios. The expected loss analysis requires an evaluation of whether the equity at risk exceeds the expected losses of the entity as a whole rather than whether it is possible that losses in excess of the equity investment at risk could occur (i.e., one loss scenario would not override the results of the entity’s expected loss computation that considers all possible scenarios on a probability-weighted basis).

**Scenario 3**

Assume the same facts as in the Background, except that the unsecured debt is not guaranteed by the equity investors and the balance sheet of BW Enterprises at the date of its inception comprises:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total assets</td>
<td>$15.0 million</td>
</tr>
<tr>
<td>Nonrecourse loan</td>
<td>7.0 million</td>
</tr>
<tr>
<td>Loans from equity investors</td>
<td>4.0 million</td>
</tr>
<tr>
<td>Other operating liabilities</td>
<td>2.5 million</td>
</tr>
<tr>
<td>Equity</td>
<td>1.5 million</td>
</tr>
</tbody>
</table>

Also assume that the $7 million nonrecourse loan has an annual interest rate of 5%, is due in four years, and is only secured by BW Enterprises’ garbage
trucks and dumpsters (i.e., it is nonrecourse to the equity investors). Additionally, the loans made by the equity investors have an annual interest rate of 20% and a 15-year term. Expected losses of BW Enterprises are $2 million.

**Evaluation**

While the expected losses of $2 million are less than the sum of the equity and loans made by the equity investors, the loans from equity investors would not be considered equity at risk (even though their returns are equity-like) because they are reported as liabilities under U.S. GAAP. Accordingly, BW Enterprises is a VIE because it does not have sufficient equity at risk as a result of the expected losses of $2 million that exceed the equity investment at risk of $1.5 million.

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**Example 4.2.40.3: Start-Up Enterprise**

**Description of the Arrangement**

A start-up enterprise, XYZ Corporation, is initially capitalized with voting common stock of $1 million and nonvoting preferred stock of $1 million. The preferred stock receives a cumulative preferred dividend of 15% before any return to the common stockholders. XYZ expects to generate an overall return of 16%. XYZ’s initial equity is sufficient to support its operations during the start-up phase.

After five years of operations, a series of unexpected events that significantly affected its business environment have eliminated XYZ’s ability to continue operations based on its existing equity. Nonetheless, XYZ’s management believes that prospects for the company are bright and develops a plan for the company to expand its operations. XYZ enters into negotiations with Venture Capital (VC) Fund to raise the necessary capital to continue its existing operations and expand those operations in the near future. XYZ issues to VC Fund:

- Senior debt of $60 million, bearing an interest rate of 8%; and
- Subordinated debt of $38 million, bearing an interest rate of 14%.

In connection with the subordinated debt issued to VC Fund, VC Fund obtains the right to nominate three out of seven members of XYZ’s board of directors. Major decisions of XYZ, such as the sale of certain assets or the execution of certain purchase or sales contracts, require the approval of the board members nominated by VC Fund, as long as the subordinated debt remains outstanding.

**Evaluation**

XYZ is not a VIE at its inception because it has equity equal to 100% of its assets (which by definition is sufficient to absorb the expected losses from
those assets because equity cannot be greater than 100% of the assets of an entity).

However, five years after inception, XYZ becomes a VIE when the equity owners give up the ability to fully control XYZ by giving participating decision-making rights to a debt holder. This action by XYZ changes the design of the entity from a voting interest entity to a VIE. The fact that XYZ incurred losses in excess of its expectations at inception does not cause it to become a VIE because those losses do not change the design of the entity.

**Question 4.2.40.7: Sufficiency of Equity for Tiered Structures**

How should sufficiency of equity be determined in structures involving multiple legal entities or levels?

**Interpretive Response:** When evaluating structures for consolidation that involve multiple legal entities at different levels, it is important to understand the purpose, design, and related risks of the structure as a whole. However, we believe that the assessment of whether an entity's equity at risk is sufficient should be performed at each legal entity and level on a stand-alone basis.

**Example 4.2.40.4: Evaluation of Sufficiency of Equity for Structures Involving Multiple Legal Entities**

**Background**

Entity B was created by Entity A to raise funding and invest in a project developed by Entity C. Entity B is initially capitalized by $20 of equity provided by Entity A and $80 of equity obtained from third-party investors. Assume Entity C is a VIE that is initially capitalized with a $10 equity investment and $90 subordinated loan from Entity B and a $900 commercial loan from an independent lending institution. Entity B consolidates Entity C because it has the power to direct the activities that most significantly impact Entity C’s economic performance and it also has an other-than-insignificant variable interest through its equity investment and subordinated loan.

**Evaluation**

When evaluating whether Entity B’s equity at risk is sufficient, the capitalization of Entity B is considered on a stand-alone basis. Although Entity B consolidates Entity C, which is capitalized largely by debt, we believe Entity B should be evaluated based on its own variable interests and whether there is sufficient equity at risk at Entity B to fund Entity B’s expected losses. In this example, because the only variable interests in Entity B are equity, Entity B will be considered sufficiently capitalized.
4.2.50. The Ability to Direct Activities

4.2.50.10. Another characteristic used to determine whether an entity is within the scope of the VIE Subsections of ASC Subtopic 810-10 is whether the holders of the equity at risk, as a group, have the power to direct the activities that most significantly impact the economic performance of the entity. If the holders of the equity at risk as a group do not have the power to direct the entity’s most significant activities, then the entity is a VIE because, without such power, the equity interests do not have the characteristics necessary to rely solely on voting control as the basis for consolidation.

4.2.50.20. To evaluate whether the characteristic in ASC subparagraph 810-10-15-14(b)(1) is met, an enterprise should (1) identify the interests that comprise the entity’s equity at risk, (2) consider the at-risk equity interests together as if they were held by one party, and (3) assess whether these at-risk equity interests, in the aggregate, provide their holders with the power to direct the activities that most significantly impact the economic performance of the entity. That third step depends on the type of entity being evaluated, as described in paragraph 4.2.50.50.

4.2.50.30. Identifying the activities that most significantly impact an entity’s economic performance requires judgment and may entail understanding the entity’s purpose and design, the nature of its activities and operations, the risks that it was designed to create and distribute to its interest holders, rights provided in contractual and/or governing documents, and rights provided through other arrangements (e.g., management or servicing agreements, etc.), among other items. When evaluating whether the at-risk equity group has the power to make significant decisions, consideration should be given to the extent to which the equity at risk group receives returns and absorbs losses. Typically, as the amount of the equity investment at risk increases, the power to direct the entity’s most significant activities becomes more important. When equity is significantly larger than expected losses, it is less likely that the holders of an at-risk equity investment would be willing to relinquish such power. Additionally, we believe the activities that most significantly impact the entity’s economic performance are the
same when determining an entity’s VIE status under ASC subparagraph 810-10-15-14(b)(1) and determining a VIE’s primary beneficiary (if any) under ASC subparagraph 810-10-25-38A(a). See Section 6 for additional guidance about identifying activities that are most significant to the entity’s economic performance.

4.2.50.40. After the entity’s most significant activities have been identified, the enterprise needs to ascertain which interests convey to their holders the power to direct those activities. Power conveyed by interests other than at-risk equity investments (even if such non-equity at-risk interests are also held by the holder of an at-risk equity investment) generally indicates that the holders of an entity’s equity at risk, as a group, lack the power to direct those activities, except as further described in this Section. The FASB believes that the VIE determination process would not be effective if it allowed equity investors to treat rights and obligations provided by their non-equity interests as if those rights were conveyed through their equity interests. In other words, that could result in an entity not being considered a VIE even though voting interests do not convey power over the entity.

4.2.50.50. The evaluation of whether the at-risk equity interests, in the aggregate, provide their holders with the power to direct the activities that most significantly impact the economic performance of the entity is performed in accordance with the characteristics applicable to the entity being evaluated. Legal entities other than limited partnerships are evaluated under ASC subparagraph 810-10-15-14(b)(1)(i) while limited partnerships and similar entities are evaluated under ASC subparagraph 810-10-15-14(b)(1)(ii). This is the only VIE characteristic for which the FASB makes a distinction in the evaluation based on the type of the entity being evaluated. For all the other VIE characteristics (ASC subparagraphs 810-10-15-14(a), 15-14(b)(2), 15-14(b)(3) and 15-14(c)), the type of legal entity is not relevant for the evaluation.

<table>
<thead>
<tr>
<th>Question 4.2.50.1: Evaluating Whether an Entity Is Similar to a Limited Partnership</th>
</tr>
</thead>
<tbody>
<tr>
<td>How should a reporting enterprise evaluate whether an entity (e.g., a limited liability company) is similar to a limited partnership?</td>
</tr>
<tr>
<td><strong>Background:</strong> The analysis of whether the entity is a VIE under ASC subparagraph 810-10-15-14(b)(1) differs for limited partnerships and corporations. Consequently, the determination of whether an entity is similar to a limited partnership is necessary for that purpose.</td>
</tr>
<tr>
<td><strong>Interpretive Response:</strong> As indicated in ASC paragraph 810-10-05-3, an entity is similar to a limited partnership when it has “governing provisions that are the functional equivalent of a limited partnership.” Entities with governing provisions that are the functional equivalent of a limited partnership have a single investor that is responsible for managing the entity’s operations. The delegation of operational authority to the managing investor is part of the agreement among all of the investors. The managing investor would meet the...</td>
</tr>
</tbody>
</table>
definition of a decision maker absent consideration of any kick-out rights or participating rights held by the other investors. A key feature that distinguishes entities that are similar to limited partnerships from other entities with an outsourced manager is that the manager’s decision-making authority in an entity that is similar to a limited partnership is conveyed through an interest that represents equity under U.S. GAAP. (For additional guidance on whether a manager’s decision-making authority is conveyed through an interest that represents equity under GAAP, see Question 4.2.50.2) Conversely, the decision-making authority of the outsourced manager in entities that are not similar to limited partnerships is not a characteristic of the manager’s GAAP equity interest (if any). That is, in entities that are not similar to limited partnerships, an outsourced manager need not hold an equity interest to obtain and maintain its contractual decision-making authority.

Question 4.2.50.2: Evaluating Whether a Decision Maker’s Power Is Conveyed Through an Equity Interest

When is a decision maker that receives fees for its services and also holds an equity-at-risk interest in an entity deemed to obtain its power through its equity-at-risk interest?

**Background**

It is common for enterprises that offer investment management services (asset managers) to hold an equity interest in the investment entities that they manage. Sometimes the equity interest is held directly by the enterprise that provides the investment management services. Sometimes, an affiliate of the enterprise that provides the investment management services holds the equity interest.

**Interpretive Response:** We believe a decision maker's power generally should be deemed to be conveyed through the equity-at-risk interest held by the decision maker or its affiliates, if an equity-at-risk interest is required to be held by the decision maker or its affiliates for the decision maker to retain the power to make the decisions that most significantly impact the entity’s economic performance. In that scenario, the entity has governing provisions that are the functional equivalent of a limited partnership and therefore the evaluation of whether the equity-at-risk investors have power should be made under ASC subparagraph 810-10-15-14(b)(1)(ii) for limited partnerships and similar entities (See Question 4.2.50.16). If the decision maker could retain the power to make the decisions that most significantly impact the entity’s economic performance even if the decision maker or its affiliates were to dispose of their equity-at-risk interests, we believe the decision maker would be deemed to obtain its power through a non-equity-at-risk interest. In that situation, the entity may not have governing provisions that are the functional equivalent of a limited partnership and, if not, the evaluation of whether the equity-at-risk investors have power should be made in accordance with ASC
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subparagraph 810-10-15-14(b)(1)(i) for entities other than limited partnerships (See Question 4.2.50.8). Consider the following examples:

**Example A:** Asset Manager receives a base fee and a performance fee for managing Investment Entity. The asset management contract requires Asset Manager to make an initial equity investment in Investment Entity and maintain an equity interest of no less than 1% for as long as it is the asset manager. Asset Manager’s power is deemed to be conveyed through its equity-at-risk interest. The entity has governing provisions that are the functional equivalent of a limited partnership and therefore the evaluation of whether the equity-at-risk investors have power should be made in accordance with ASC subparagraph 810-10-15-14(b)(1)(ii) for limited partnerships and similar entities. Investment Entity would be a VIE unless the equity-at-risk investors excluding Asset Manager, parties under common control with Asset Manager, and parties acting on behalf of Asset Manager, have substantive kick-out rights or substantive participating rights over Asset Manager.

**Example B:** Asset Manager receives a base fee and a performance fee for managing Investment Entity. Asset Manager makes an initial equity investment in Investment Entity and is not permitted to sell its equity interest without the consent of Investment Entity’s other investors. Asset Manager’s power is deemed to be conveyed through its equity-at-risk interest. The entity has governing provisions that are the functional equivalent of a limited partnership and therefore the evaluation of whether the equity-at-risk investors have power should be made under ASC subparagraph 810-10-15-14(b)(1)(ii) for limited partnerships and similar entities. Investment Entity would be a VIE unless the equity-at-risk investors excluding Asset Manager, parties under common control with Asset Manager, and parties acting on behalf of Asset Manager, have substantive kick-out rights or substantive participating rights over Asset Manager.

**Example C:** Asset Manager receives a base fee and a performance fee for managing Investment Entity. Asset Manager makes an initial equity investment in Investment Entity and is permitted to sell its equity interest without the consent of Investment Entity’s other investors. Asset Manager’s power is deemed to be conveyed through its non-equity-at-risk interest. Investment Entity may not have governing provisions that are the functional equivalent of a limited partnership and, if not, the evaluation of whether the equity-at-risk investors have power should be made under ASC subparagraph 810-10-15-14(b)(1)(i) for entities other than limited partnerships. If Investment Entity is not a limited partnership or similar entity and Asset Manager’s fees are a variable interest under the provisions of ASC paragraph 810-10-55-37 (see Subsection 3.5), further evaluation is required to determine whether the condition in ASC subparagraph 810-10-15-14(b)(1)(i) is met.
Example D: Asset Manager receives a base fee and a performance fee for managing Investment Entity. The asset management contract requires an affiliate of Asset Manager to make an initial equity investment in Investment Entity and maintain an equity interest of no less than 1% for as long as Asset Manager is the asset manager. In this scenario, Asset Manager’s power is deemed to be conveyed through the equity-at-risk interest of its affiliate. The entity has governing provisions that are the functional equivalent of a limited partnership and therefore the evaluation of whether the equity-at-risk investors have power should be made under ASC subparagraph 810-10-15-14(b)(1)(ii) for limited partnerships and similar entities. Investment Entity would be a VIE unless the equity-at-risk investors excluding Asset Manager, parties under common control with Asset Manager, and parties acting on behalf of Asset Manager, have substantive kick-out rights or substantive participating rights over Asset Manager.

Question 4.2.50.3: Power Conveyed Through Equity and Non-Equity Instruments

Would an entity be considered a VIE under ASC subparagraph 810-10-15-14(b)(1) if power is conveyed by a combination of equity and non-equity interests and all non-equity instruments are held by the holders of the equity investment at risk?

Interpretive Response: The answer depends on the extent to which the non-equity interests provide their holders with the power to direct the activities that most significantly impact the entity’s economic performance. If power is conveyed to an interest holder through anything other than an equity investment at risk, then the entity is a VIE under ASC subparagraph 810-10-15-14(b)(1). However, if the equity investment at risk is the only interest that provides the entity’s variable interest holders with power, then the condition in ASC subparagraph 810-10-15-14(b)(1) would not be met. The following example illustrates this concept:

Background

Enterprise A and Enterprise B form a venture that is capitalized by the issuance of both debt and equity interests. Enterprise A invests $250 in exchange for equity with a 25% voting interest. Enterprise B invests $750 in exchange for equity with a 25% voting interest and debt with a 50% voting interest. All decisions for the venture must be approved by a simple majority vote.

Evaluation

While the voting interests are entirely held by the holders of the equity investment at risk, the equity interests do not convey the power to direct the activities that most significantly impact the venture’s economic
performance. This is because only 50% (less than a majority) of the voting rights are conveyed via the venture's equity interests. However, if Enterprise B invested $750 in exchange for equity with a 45% voting interest and debt with a 30% voting interest, the condition in ASC subparagraph 810-10-15-14(b)(1) would not be met. In that circumstance, the equity-at-risk investors would have the power to direct the activities that most significantly impact the venture's economic performance using the votes attributed to the equity interests (i.e., equity interests hold a 70% vote, which exceeds the simple majority vote needed to make decisions).

**Question 4.2.50.4: VIE Determination versus Primary Beneficiary Determination**

Is the evaluation of power under ASC subparagraph 810-10-15-14(b)(1) to determine whether an entity is a VIE consistent with the analysis of power under ASC subparagraph 810-10-25-38A(a) to determine the primary beneficiary of a VIE?

**Interpretive Response:** Not entirely. The evaluation of power under ASC subparagraph 810-10-15-14(b)(1) is different for limited partnerships and similar entities than it is for corporations and other entities that are not similar to limited partnerships. ASC subparagraph 810-10-25-38A(b) does not make this distinction.

In addition, the analysis of whether an entity is a VIE when considering substantive kick-out rights and participating rights in ASC subparagraph 810-10-15-14(b)(1) differs from the analysis of how those rights affect the determination of whether a variable interest holder has power over a VIE in ASC subparagraph 810-10-25-38A(a) in two ways:

- For legal entities that are not similar to limited partnerships, a simple majority or lower threshold of kick-out rights and participating rights may be considered in evaluating ASC subparagraph 810-10-15-14(b)(1)(i) (see Question 4.2.50.8) to determine whether an entity is a VIE whereas the power criterion evaluation in ASC subparagraph 810-10-25-38A(a) requires a single party (or single group of related parties and de facto agents) with the unilateral ability to exercise such rights when identifying the primary beneficiary of a VIE;

- For limited partnerships and similar entities, participating rights are evaluated in ASC subparagraph 810-10-15-14(b)(1)(ii) to determine whether an entity is a VIE in the context of the activities that occur in the ordinary course of the entity's business, whereas the power criterion in ASC subparagraph 810-10-25-38A(a) is evaluated in the context of the activities that most significantly impact the entity's economic performance for purposes of identifying the primary beneficiary of a VIE. In addition, a simple majority or lower threshold...
of kick-out rights and participating rights held by the limited partners (excluding limited partner interests held by the general partner, entities under common control with the general partner, or parties acting on behalf of the general partner) is considered in evaluating ASC subparagraph 810-10-15-14(b)(1)(ii) whereas the power criterion evaluation in ASC subparagraph 810-10-25-38A(a) is only met when a single party (or group of related parties and de facto agents) has the unilateral ability to exercise such rights.

See Section 6 for additional guidance on the primary beneficiary determination.

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**Question 4.2.50.5: Group of Equity Investors for Purposes of Evaluating Power**

Are the holders of an equity investment at risk under ASC subparagraph 810-10-15-14(a) for purposes of determining the sufficiency of an entity’s equity the same as the holders of equity at risk under ASC subparagraph 810-10-15-14(b)(1) when determining whether the at-risk equity investors, as a group, have power?

**Interpretive Response:** The answer depends on the type of entity being evaluated.

For entities other than limited partnerships and similar entities (e.g., corporations), the holders of an entity’s equity investment at risk are the same for purposes of evaluating (1) the sufficiency of an entity’s equity and (2) whether the equity investors have the power to direct the activities that most significantly impact the economic performance of the entity. For example, an enterprise may have received an equity interest as fees in exchange for providing administrative services (*sweat equity*). Because the entity is providing those interests to the enterprise as fees in exchange for the services provided, it would not be considered equity at risk in determining whether the equity at risk is sufficient or whether the at-risk equity investors, as a group, have power.

For limited partnerships and similar entities, voting equity-at-risk interests held by the general partner (or equivalent), entities under common control with the general partner or other parties acting on behalf of the general partner (or equivalent), are included in evaluating the sufficiency of an entity’s equity but are *excluded* in evaluating whether the equity-at-risk investors, as a group, have power (see paragraph 4.2.50.120).
Question 4.2.50.6: Only Some Holders of Equity At Risk Have Power

If some, but not all, of the equity-at-risk investors (i.e., less than 100%) collectively have the power to direct the activities that most significantly impact an entity’s economic performance, would the characteristic in ASC subparagraph 810-10-15-14(b)(1) be met (i.e., the entity is a VIE)?

Interpretive Response: No, because this test is applied to the at-risk equity investors as a group (rather than individually). Therefore, all equity-at-risk investors are not required to share power as long as power is held by some of the holder(s) of an equity investment at risk. It is also important to note that for the holders of the equity investment at risk as a group to have power, the decision-making rights must be conveyed through at-risk equity investments. As discussed later in this Section, power that is conveyed by an interest other than the at-risk equity investments (e.g., servicing or management agreement, equity investment that is not at risk, etc.) may not provide the entity’s equity-at-risk investors with the power to direct the activities that most significantly impact the entity’s economic performance. In addition, as discussed in Question 4.2.50.1, under ASC subparagraph 810-10-15-14(b)(1) the evaluation of whether the equity-at-risk investors have the power to direct the activities that most significantly impact an entity’s economic performance will depend on whether the entity being evaluated is a limited partnership or similar entity or is a different type of entity (e.g., a corporation).

The following example illustrates how power can be held by the equity-at-risk investors as a group without being shared by all of the equity-at-risk investors for a legal entity other than a limited partnership:

Background

Three investors form a venture to develop and manufacture a video gaming console. Investors A and B collectively contribute $2,500 for all of the entity’s voting common stock and Investor C contributes $7,500 for all of the entity’s non-voting preferred stock. For this example, assume that all equity interests are at risk under ASC subparagraph 810-10-15-14(a). The equity interests of Investors A and B convey all of the venture’s voting rights thereby providing those investors the power to make the decisions that most significantly impact the economic performance of the entity. Investor C does not have any voting rights.

Evaluation

Because all equity interests are deemed to be at risk, we believe the equity investors, as a group, would have the power to direct the activities that most significantly impact the entity’s economic performance even though the investors with voting rights only hold 25% of the outstanding equity. However, where the voting rights of an equity investor are disproportional to its share of the entity’s variability, the enterprise should consider whether the conditions in ASC subparagraph...
810-10-15-14(c) have been met. This is discussed in greater detail later in this Section.

**Question 4.2.50.7: Nature of Power Over an Entity’s Activities**

What type of activities should the holders of the equity investment at risk, as a group, have power over to demonstrate that they have the power to direct the activities that most significantly impact the economic performance of an entity?

Interpretive Response: The power held by the holders of equity at risk, as a group, must enable them to make substantive decisions that most significantly impact the economic performance of the entity, which may include the ability to control decisions that affect the entity's revenues, expenses, profits, losses, and other key performance indicators. Control over decisions limited to administrative functions generally would not convey power to the equity investors. Determining whether, as a group, the holders of the equity investment at risk have the power will be based on the applicable facts and circumstances and will require professional judgment. Some examples of substantive decisions that collectively may significantly impact an entity’s economic performance include the ability to enter into new businesses, buy or sell assets, and obtain additional financing, among others. See also Question 4.2.50.8 for the power held by the holders of equity at risk when a legal entity other than a limited partnership has an outsourced decision maker.

**LEGAL ENTITIES OTHER THAN LIMITED PARTNERSHIPS AND SIMILAR ENTITIES**

4.2.50.60. With FASB Accounting Standards Update No. 2015-02 (ASU 2015-02), *Amendments to the Consolidation Analysis*, eliminating the indefinite deferral of ASU 2009-17 provided for certain entities in FASB Accounting Standards Update No. 2010-10 (ASU 2010-10), *Amendments for Certain Investment Funds*, some constituents expressed concerns that many mutual funds would be considered VIEs because the holders of the equity at risk as a group would not have the power through voting rights or similar rights to direct the activities that most significantly impact the fund’s economic performance. Specifically, a single equity-at-risk investor would not have a substantive unilateral kick-out right or participating right over the asset manager when the asset manager has the power to direct the activities that most significantly impact the potential VIE’s economic performance and the asset manager’s fee is considered a variable interest. This outcome would have potentially required consolidation of these entities by asset managers that hold a portion of the entities’ investment interests until their interests fell below the potentially significant variable interest threshold (rather than the majority exposure to variability threshold applied under the ASU 2010-10 deferral of ASU 2009-17).
4.2.50.70. To address these concerns, the FASB decided that equity-at-risk investors may have the power through voting rights or similar rights to direct the activities that most significantly impact a potential VIE’s economic performance, even though the potential VIE has an outsourced manager with contractual decision-making rights. To demonstrate this, the Board provided an example in paragraph BC35 of ASU 2015-02 where the equity investors’ voting rights provide them with the power to elect the entity’s board of directors and the board is actively involved in making decisions about activities that most significantly impact an entity’s economic performance. The FASB also added an illustrative example in the implementation guidance related to series mutual funds to demonstrate how the equity investors may have power through voting rights even if the entity has an outsourced manager such as an investment manager. The example indicates that the equity-at-risk investors have power over the activities that most significantly impact the entity’s economic performance, and therefore the entity is not a VIE based on this characteristic, because the equity at-risk investors have simple majority voting rights over all of the following (1) the replacement of the decision maker, (2) the approval of the decision maker’s compensation, and (3) the investment strategy of the entity. In other words, the equity interests have the characteristics necessary to rely on voting control as the basis for the consolidation analysis.

4.2.50.80. If interests other than equity at risk investments contain rights to direct the activities that most significantly impact an entity’s economic performance, further analysis is necessary as described in this Section. Determining whether an entity is a VIE because it has a decision maker or service provider that has power through an interest separate from an equity investment at risk depends in part on whether or not the fee arrangement represents a variable interest under ASC paragraph 810-10-55-37. If the fee arrangement is not a variable interest, then the decision maker or service provider is deemed to be acting in a fiduciary capacity (i.e., as an agent of the equity investors) rather than as a principal to the transaction. In these situations, the criterion in ASC subparagraph 810-10-15-14(b)(1)(i) is not met because a decision maker or service provider acting in a fiduciary capacity could never be the VIE’s primary beneficiary. If the fee arrangement is a variable interest, then further evaluation is required to determine whether the entity is a VIE.

**Question 4.2.50.8: Evaluating Whether the Equity-at-Risk Investors of a Corporation Have Power**

How should a reporting enterprise evaluate whether the equity-at-risk investors, as a group, have the power, through voting rights or similar rights, to direct the activities that most significantly impact the economic performance of a corporation when:

(a) The corporation has an outsourced manager with the contractual right to make the decisions that most significantly impact the corporation’s economic performance, and
(b) The manager’s fee is considered a variable interest?

**Interpretive Response:** The FASB changed the requirements for evaluating whether the equity-at-risk investors of entities that are not similar to limited partnerships (including corporations) have power through voting rights or similar rights to direct the activities that most significantly impact an entity’s economic performance. Under the pre-ASU 2015-02 consolidation guidance, when a corporation has a decision maker whose fee is a variable interest, there must be a single party or related party group with a substantive unilateral kick-out right or participating right over the decision maker for the corporation to be eligible to be a voting interest entity. ASU 2015-02’s changes appear to indirectly eliminate this requirement. According to ASC subparagraph 810-10-15-14(b)(1)(i), the new evaluation of whether the equity-at-risk investors of entities that are not similar to limited partnerships have power is a two-step process as illustrated below.

The FASB also stated in paragraph BC35 of ASU 2015-02 that “two steps are required to evaluate the condition in ASC subparagraph 810-10-15-14(b)(1)(i), which may be a change to practice.” However, other guidance in the ASU suggests that there may be only a single-step evaluation as illustrated below.
The primary guidance indicating that the evaluation of the condition in ASC subparagraph 810-10-15-14(b)(1)(i) is a single-step process is provided by ASU 2015-02’s illustrative example of a series mutual fund. The FASB added this example to demonstrate the evaluation in ASC subparagraph 810-10-15-14(1)(b)(i). However, the Board indicated in paragraph BC36 of the ASU that it does not intend for the new analysis to apply only to series mutual funds.

**Excerpt from ASC Subtopic 810-10**

**Example of a Series Mutual Fund**

55-8A An asset management company creates a series fund structure in which there are multiple mutual funds (Fund A, Fund B, and Fund C) within one (umbrella) trust. Each mutual fund, referred to as a series fund, represents a separate structure and legal entity. The asset management company sells shares in each series fund to external shareholders. Each series fund is required to comply with the requirements included in the Investment Company Act of 1940 for registered mutual funds.

55-8B The purpose, objective, and strategy of each series fund are established at formation and agreed upon by the shareholders in accordance
with the operating agreements. Returns of each series fund are allocated only to that respective fund’s shareholders. There is no cross-collateralization among the individual series funds.

Each series fund has its own fund management team, employed by the asset management company, which has the ability to carry out the investment strategy approved by the fund shareholders and manage the investments of the series fund. The Board of Trustees is established at the (umbrella) trust level.

55-8C The asset management company is compensated on the basis of an established percentage of assets under management in the respective series funds for directing the activities of each fund within its stated objectives. The fees paid to the asset management company are both of the following:

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

55-8D The asset management company has sold 65 percent of the shares in Fund A to external shareholders and holds the remaining 35 percent of shares in Fund A.

55-8E The shareholders in each series fund have the ability through voting rights to do the following:

(a) Remove and replace the Board of Trustees
(b) Remove and replace the asset management company
(c) Vote on the compensation of the asset management company
(d) Vote on changes to the fundamental investment strategy of the fund
(e) Approve the sale of substantially all of the assets of the fund
(f) Approve a merger and/or reorganization of the fund
(g) Approve the liquidation or dissolution of the fund
(h) Approve charter and bylaw amendments
(i) Increase the authorized number of shares.

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

55-8G According to paragraph 810-10-15-14(b)(1), one condition for a legal entity to be considered a VIE is that, as a group, the holders of the equity investment at risk lack the power, through voting rights or similar rights, to direct the activities of a legal entity that most significantly impact the entity’s economic performance.

Paragraph 810-10-15-14(b)(1)(i) indicates that, for legal entities other than limited partnerships, investors lack that power through voting rights or similar rights if no owners hold voting rights or similar rights (such as those of a common shareholder in a corporation).

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

As indicated in ASC paragraph 810-10-55-8H, in this example, the shareholders of each series mutual fund have the ability to direct the activities that most significantly impact the fund’s economic performance through their voting rights. Based on the definitions of kick-out rights, participating rights, and protective rights, the shareholders’ power in this instance is solely attributable to substantive kick-out rights or substantive participating rights. The shareholder rights at the series mutual fund level are described in ASC paragraphs 810-10-55-8E and 55-8F. Those rights are associated with the VIE definitions of kick-out rights, participating rights, and protective rights in the following table.
Although ASC paragraph 810-10-55-8H states that the shareholders’ right to vote on the investment strategy of the series mutual fund is one of the reasons the shareholders have power through voting rights, that right meets the definition of a protective right. Specifically, the investment strategy of a series mutual fund is established at its formation by its sponsor or advisor before investment interests are sold to third parties (see ASC paragraph 810-10-55-8B). In addition, the investment strategy of a mutual fund is part of its design and is usually fairly general in nature. That is, there usually are numerous investments that are consistent with a mutual fund’s investment strategy.

Acceptance of the investment strategy is a decision to invest, not a right that conveys power over the activities that most significantly impact the economic performance of a series mutual fund. The selection of specific investments (which the shareholders do not have the right to approve) is what usually significantly impacts a mutual fund’s economic performance. Once established, a mutual fund’s investment strategy would not be expected to change. Therefore, a shareholder’s right to vote on the investment strategy after making an initial investment decision is consistent with the definition of a protective right. Under the provisions of ASC subparagraph 810-10-15-14(b)(1), protective rights are not necessary to support the conclusion that the shareholders have power through voting rights.

The right to replace the asset manager and approve the asset manager’s compensation could meet the definition of either a substantive kick-out right or a substantive participating right. ASC paragraph 810-10-25-11 describes the right to participate in selecting, terminating, and setting the compensation of management responsible for implementing the entity’s policies and procedures as a substantive participating right. If the asset manager is the equivalent of management responsible for implementing the entity’s policies and procedures, then the right to replace the asset manager and approve the asset manager’s compensation generally would qualify as a substantive participating right. More traditionally, this type of right generally would be considered a substantive kick-out right because the asset manager is a single party with the contractual right (before considering the effect of substantive kick-out rights or
substantive participating rights) to make the decisions that most significantly impact the entity’s economic performance.

In light of the considerations discussed above, the substantive kick-out rights or substantive participating rights held by the shareholders of each series mutual fund are sufficient, in and of themselves, to support the conclusion that the shareholders have power. This is true even though the rights are exercisable on a simple-majority voting basis - i.e., there is no single shareholder that can unilaterally exercise those rights.

Using the analysis above, we are not currently aware of a scenario where the evaluation in ASC subparagraph 810-10-15-14(b)(1)(i) would progress to the second step described by the FASB. It appears that the equity-at-risk investors either will have power under the evaluation in the first step (which may be through substantive kick-out rights or substantive participating rights) or they will not. If they do not have power under the evaluation in the first step, they will not have power under the second step either. When voting rights of a single equity-at-risk investor provide that investor a substantive kick-out right or substantive participating right that is unilaterally exercisable, the equity-at-risk investors as a group will have power under the first step and the evaluation will not progress to the second step.

The guidance in ASC subparagraph 810-10-15-14(b)(1) on substantive kick-out rights and substantive participating rights therefore works much the same way for all entities (i.e., whether or not similar to limited partnerships), except for the related party limitations that apply to limited partnerships and similar entities. That is, we are not currently aware of a scenario under which a unilaterally-exercisable substantive kick-out right or substantive participating right is required for a corporation to be a voting interest entity.

Additionally, shareholders may have power through voting rights over the activities that most significantly impact the entity’s economic performance through rights exercised by a board of directors elected by the shareholders. If there is a substantive process whereby the board of directors is elected by the shareholders and is acting on their behalf, the rights of the board of directors would be evaluated as rights of the shareholders. For example, shareholders would have power if the board of directors is actively involved in making decisions about the activities that most significantly impact the entity’s economic performance and there is a regular periodic process for the shareholders to make changes to the board members. Such decisions may include the right to replace the decision maker (e.g., asset manager) with or without cause and approve its compensation.
Question 4.2.50.9: Evaluating Whether the Shareholders Have the Power to Direct the Most Significant Activities of a Corporation Through a Board of Directors

Can the shareholders of a corporation have the power to direct the activities that most significantly impact its economic performance for purposes of the VIE criterion in ASC subparagraph 810-10-15-14(b)(1)(i) through a simple majority right to elect the corporation’s board of directors?

Interpretive Response: Yes. If there is a substantive process whereby the board of directors is elected by a simple majority vote of the shareholders’ voting equity-at-risk interests and is acting on their behalf, the rights of the board of directors would be evaluated as rights of the shareholders. In that situation, shareholders would have power if the board of directors is actively involved in making decisions about the activities that most significantly impact the corporation’s economic performance and there is a regular periodic process for the shareholders to make changes to the board members. A board’s delegation of the day-to-day execution of its decisions to a management team or third-party decision maker does not preclude a conclusion that the board is actively involved in making decisions about the activities that most significantly impact a corporation’s economic performance if there is a frequent and sufficiently detailed reporting mechanism whereby the board is able to monitor the performance of the management team or decision maker on a timely basis. In addition, in those situations, the board should have the right to replace the management team or decision maker without cause and approve their compensation.

Note that a board of directors does not create new rights for shareholders; rather it is a reflection of, or pass-through mechanism for the exercise of, the shareholders’ rights. As such, we believe that a board of directors cannot be considered to have power for purposes of analyzing an entity under the VIE Subsections of ASC Subtopic 810-10. A board of directors comprises more than one individual; therefore, kick-out rights exercisable by a board should not be considered when determining whether one party has a unilateral ability to exercise substantive kick-out rights unless a single shareholder (or group of related party shareholders) has the unilateral ability to select the requisite number of board members necessary to control the entity or the power to direct the board’s actions for purposes of determining the primary beneficiary of a VIE as discussed in Question 6.2.60.1.
Question 4.2.50.10: Determining When Unilaterally-Exercisable Substantive Kick-Out or Substantive Participating Rights Are Required for an Entity to Be a Voting Interest Entity

When are unilaterally-exercisable substantive kick-out rights or substantive participating rights required to conclude that an entity is a voting interest entity?

Interpretive Response: As discussed in Question 4.2.50.8, unilaterally-exercisable substantive kick-out rights or substantive participating rights are not required to conclude that an entity of any kind is a voting interest entity. Therefore the analysis in ASC subparagraph 810-10-15-14(b)(1)(i) likely would not progress to the second step described in that paragraph. However, it is important to note that only unilaterally-exercisable substantive kick-out rights or substantive participating rights are relevant when evaluating which party, if any, is the primary beneficiary of an entity that is a VIE.

Question 4.2.50.11: Kick-Out Rights (VIE Definition)

Are liquidation rights considered kick-out rights under the VIE definition?

Interpretive Response: Yes. This question was addressed by the Board in paragraph BC 49 of the Basis for Conclusions to ASU 2015-02, which states:

In deliberating the proposed amendments in the 2011 Exposure Draft, the Board decided that liquidation rights should be considered equivalent to kick-out rights. Liquidation rights provide the holders of such rights with the ability to dissolve the entity and, thus, effectively remove the decision maker’s authority. The Board considered evaluating liquidation rights in a manner similar to kick-out rights only when it is reasonable that upon liquidation, the investors will receive substantially all of the specific assets under management and can find a replacement manager with sufficient skills to manage those assets. The basis for this view is that it may be less likely for the holders to exercise their liquidation rights if they would not receive the assets under management or if they would be unlikely to find a replacement for the current decision maker. The Board ultimately rejected this view because the outcome for the decision maker is the same regardless of whether the holders of those rights have the ability to obtain the specific assets from the entity upon liquidation or identify an alternative manager. If the holders exercise their substantive liquidation rights, similar to kick-out rights, the decision maker’s abilities would be removed. Barriers to exercise may be different when considering kick-out rights as compared with barriers for liquidation rights and should be evaluated appropriately when assessing whether the rights are substantive. The Board’s decision was consistent with the definition of kick-out rights originally included in Subtopic 810-20.
Question 4.2.50.12: Redemption (Withdrawal) Rights

Are redemption (withdrawal) rights considered the equivalent of kick-out rights under the VIE definition?

Interpretive Response: Generally no. However, in rare cases withdrawal rights may implicitly require liquidation of an entity and therefore function similar to substantive kick-out rights. A scenario in which a withdrawal right would be similar to a substantive kick-out right is when an investor holds a substantial portion of the investment interests in a fund with illiquid investments such that a withdrawal by the investor of its investment in the fund would compel the fund to liquidate all of its investments to satisfy the investor’s withdrawal right, provided that there were no significant barriers to the exercise of that right. Withdrawal rights that do not either explicitly or implicitly require dissolution or liquidation of the entity would not be considered similar to a substantive kick-out right. This is consistent with the Board’s intentions as described in paragraph BC53 of the Basis for Conclusions to ASU 2015-02, which states in part:

[T]he Board also reconsidered whether redemption rights should be considered equivalent to kick-out rights. Redemption rights represent an entity’s obligation to return provided capital to an investor upon the investor’s request. While redemption rights do not provide an investor with the power to remove a decision maker, stakeholders pointed out that in some cases redemption may require liquidation of all of the entity’s assets if exercised. Investors could theoretically withdraw 100 percent of an entity’s capital (assuming there are no restrictions in place) and effectively kick out the decision maker. While this scenario may be rare in circumstances with many investors, it might be plausible for an entity that has few investors.

Paragraph BC54 of the Basis for Conclusions to ASU 2015-02 goes on to say:

During redeliberations, the Board considered treating kick-out and redemption rights in a similar manner in certain circumstances depending on their effectiveness, but it ultimately concluded that redemption rights are not the equivalent of kick-out rights. The Board observed that while the exercise of redemption rights may occasionally lead to liquidation, those rights are inherently different from liquidation rights or kick-out rights and the economics are not the same. The Board questioned why a reporting entity would not just provide kick-out rights in a situation in which redemption rights would be clearly equivalent. The Board’s conclusion is consistent with the guidance previously included in paragraph 810-20-25-9, which states that “... the limited partners’ unilateral right to withdraw from the partnership in whole or in part (withdrawal right) that does not require dissolution or liquidation of the entire limited partnership would not overcome the presumption that
Question 4.2.50.13: Entities Affected by Kick-Out Rights Requirements

In what types of entities is the evaluation of ASC subparagraph 810-10-15-14(b)(1)(i) most likely to be affected by kick-out rights or participating rights?

Interpretive Response: Entities in which kick-out rights or participating rights are most likely to affect the evaluation of ASC subparagraph 810-10-15-14(b)(1)(i) include certain investment companies.

Under ASC subparagraph 810-10-15-14(b)(1)(i), if the decision maker is not considered part of the equity-at-risk group, a reporting enterprise would need to perform the two-step approach described in paragraph 4.2.50.70 and further illustrated in Question 4.2.50.8. The following examples illustrate the thought process.

Facts Applicable to All Scenarios: ABC Investment Fund is established with $20 million of assets under management. There are three unrelated members that hold these ABC equity interests:

Investor A – 30%
Investor B – 30%
Investor C – 40%

ABC hires Asset Manager to monitor the assets it holds and make all decisions related to managing those assets (i.e., the purchase or sale of ABC’s assets). Asset Manager is considered the decision maker and receives a fee for its services. ABC does not meet the criteria in ASC subparagraphs 810-10-15-14(a), 15-14(b)(2), 15-14(b)(3), and 15-14(c).

Example A: The fee paid to Asset Manager is not a variable interest under ASC paragraph 810-10-55-37, and ABC’s equity-at-risk investors do not have substantive kick-out or participating rights over Asset Manager.

Evaluation

ABC is not a VIE. If the fee paid to Asset Manager is not a variable interest under ASC paragraph 810-10-55-37, the equity group at risk would be deemed to have the power through voting rights or similar rights to direct the activities that most significantly impact ABC’s economic performance. ABC would be evaluated for consolidation as a voting interest entity.

Example B: The fee paid to Asset Manager is a variable interest under ASC paragraph 810-10-55-37, and ABC’s equity-at-risk investors do not have substantive kick-out or participating rights over Asset Manager.
Evaluation

ABC is a VIE. In this situation, Asset Manager is not part of the equity-at-risk group, but has the power to direct the activities that most significantly impact ABC’s economic performance. Therefore, as a group, the holders of the equity investment at risk would be deemed to lack the power to direct the activities that most significantly impact ABC’s economic performance. ABC would meet the criterion in ASC subparagraph 810-10-15-14(b)(1)(i) and would be evaluated for consolidation as a VIE.

Example C: The fee paid to Asset Manager is a variable interest under ASC paragraph 810-10-55-37 and ABC’s equity-at-risk investors have simple majority voting rights over all of the following (1) the replacement of Asset Manager, (2) the approval of Asset Manager’s compensation, and (3) the investment strategy of the entity.

Evaluation

ABC is not a VIE. The equity-at-risk investors are considered to have power over the activities that most significantly impact ABC’s economic performance. Accordingly, ABC would not meet the criterion in ASC subparagraph 810-10-15-14(b)(1)(i) and would be evaluated for consolidation as a voting interest entity.

4.2.50.90. The analysis described above applies to all legal entities that are not similar to limited partnerships, not just series mutual funds. Therefore, the analysis is likely to have an effect on other legal entities for which decision-making rights are held through a contractual arrangement. Consider the following example:

Example 4.2.50.1: Research and Development Venture

Three investors create a legal entity intended to develop and commercialize a new medication. The entity does not qualify for the business scope exception in ASC subparagraph 810-10-15-17(d). Each investor contributes the same amount of equity and holds an equal percentage of voting rights (i.e., there is no disproportionality between voting rights and economic rights), which are substantive. Each investor’s equity meets the requirements to be considered at-risk. The entity has sufficient equity at risk to finance its activities without additional subordinated financial support. The investors also are not protected from absorbing the expected losses of the entity and have the right to receive its expected residual returns. The investors hire an unrelated third-party manager to oversee the research and development activities. The venture agreement requires a simple majority of the voting rights to approve the following decisions: the removal of the manager, the compensation of the manager, and the strategy of the entity. The fees paid to the manager represent a variable interest under ASC paragraph 810-10-55-37.
Evaluation

The venture agreement requires a vote of no more than two of the three investors to approve the removal of the manager, the compensation of the manager, and the strategy of the entity. Accordingly, the three investors as a group have the power to direct the activities that most significantly impact the entity’s economic performance. Because the entity also has no other characteristics of a VIE, it is not a VIE. None of the investors would consolidate the entity.

Note that the conclusions above would not change if the fee paid to the manager was not a variable interest under ASC paragraph 810-10-55-37 - even if the three investors as a group did not have substantive kick-out or participating rights over the manager. The manager would be deemed to be acting as an agent because its fee is not a variable interest in the entity.

4.2.50.100. Under U.S. GAAP prior to ASU 2015-02, an entity is considered a VIE when a decision maker or service provider whose fee is a variable interest has the power to direct the activities that most significantly impact the entity’s economic performance through a contractual arrangement and there is no single equity-at-risk investor with substantive unilateral kick-out rights or participating rights. The analysis introduced by ASU 2015-02 in ASC subparagraph 810-10-15-14(b)(1)(i) therefore represents a significant change to the VIE criteria on voting rights for entities that are not similar to limited partnerships. The Board acknowledged in the ASU’s Basis for Conclusions that this may be a change in practice.

4.2.50.110. If non-equity interest holders possess kick-out rights or participating rights, they only prevent the at-risk equity investors from possessing power if they are unilaterally exercisable (i.e., exercisable by a single party or related party group) and relate to the activities that most significantly impact the entity’s economic performance. It is unusual in practice for non-equity interest holders to possess unilaterally-exercisable kick-out rights or participating rights conveying power.

Question 4.2.50.14: Participation of Non-Equity-At-Risk Investors in Decision Making

If the holder of a non-equity at risk variable interest substantively participates in decision making, is the entity considered a VIE under ASC subparagraph 810-10-15-14(b)(1)(i)?

Interpretive Response: If the holder (including its related parties and de facto agents) of an interest that is not considered an equity investment at risk has substantive participating rights, the entity would be considered a VIE under ASC subparagraph 810-10-15-14(b)(1)(i). When evaluating participating rights, we believe that the non-equity at risk interest holder’s ability to block the actions through which at-risk equity investors may exercise power is an important consideration. However, if the participating rights are held collectively
by multiple unrelated parties through interests that are not at-risk equity investments, the condition in ASC subparagraph 810-10-15-14(b)(1)(i) may not be met. The following examples illustrate this concept:

**Example A:** Three unaffiliated investors (X, Y, and Z) form a venture. Investors X, Y, and Z contribute $800, $100, and $100, respectively, and receive equity interests of 80%, 10%, and 10%, respectively. Investors Y and Z have the ability to put (sell) their equity interests to Investor X after three years for the amount of their initial equity contributions. Investor X has all substantive decision-making rights; however, Investor Z has the right to block any of Investor X’s decisions.

**Evaluation**

Because Investors Y and Z have the ability to put their equity interests back to Investor X, their interests would not be considered equity at risk under ASC subparagraph 810-10-15-14(a) because they are shielded from participating significantly in the partnership’s losses. Investor X also is unable to unilaterally make decisions because Investor Z can block all of its actions. Because Investor Z possesses substantive participating rights (i.e., the ability to block Investor X’s decisions) through a non-equity at risk investment, the venture is a VIE under ASC subparagraph 810-10-15-14(b)(1)(i)(01).

**Example B:** Assume in Example A that Enterprises Y and Z both need to agree to block Enterprise X’s decisions.

**Evaluation**

Because the participating rights are held collectively by multiple unrelated parties, we believe that the condition in ASC subparagraph 810-10-15-14(b)(1)(i)(01) would not be met.

**Example C:** CKW Pharmaceutical (CKW) forms a venture (CAB) with Entity A and Entity B to manufacture and distribute over-the-counter pain relievers. CKW contributes its over-the-counter pain reliever business line worth $9 million in exchange for a 45% equity interest in CAB. Entity A and Entity B each contribute $5.5 million in cash in exchange for a 27.5% equity interest. However, Entity A has the ability to put (sell) its equity interest to CKW for the amount paid ($5.5 million) after the third year. Under the terms of CAB’s legal agreements, all decisions must be determined based on a unanimous vote by all three equity investors.

**Evaluation**

In this scenario, Entity A’s equity investment is not deemed to be at risk under ASC subparagraph 810-10-15-14(a) because the put option protects it from participating significantly in CAB’s losses. Because the holder of an equity investment that is not considered at risk has the substantive ability to block all decisions (due to the requirement for a
unanimous vote), the entity is a VIE under ASC subparagraph 810-10-15-14(b)(1)(i)(01). That is, the at-risk equity group does not have the power to make the decisions that most significantly impact the economic performance of CKW.

Example D: Assume the same facts as in Example C, except that Entity A only has protective rights. That is, Entity A can only vote on decisions other than those that most significantly impact CAB’s economic performance.

Evaluation
Because Entity A is only permitted to vote on decisions other than those that most significantly impact CAB’s economic performance, CAB would not meet the condition in ASC subparagraph 810-10-15-14(b)(1)(i). In this scenario, only holders of at-risk equity (CKW and Entity B) have the power to direct the activities that most significantly impact CAB’s economic performance.

Example E: Assume the same facts as in Example C, except that Entity A does not have the ability to put its equity investment to CKW. Instead, CKW has the right to call Entity A’s investment for $8 million after three years.

Evaluation
The evaluation of whether CAB is a VIE in this scenario depends on whether the call option would preclude Entity A from participating significantly in the profits of CAB. If the call option is deemed to prevent Entity A from participating significantly in CAB’s profits, then Entity A’s equity investment is not deemed to be at risk under ASC subparagraph 810-10-15-14(a). This would result in CAB being deemed a VIE under ASC subparagraph 810-10-15-14(b)(1)(i)(01) because the holder of an equity investment that is not considered at risk has the substantive ability to block all decisions (due to the requirement for a unanimous vote).

Question 4.2.50.15: Power Conveyed by Franchise Agreements
Many franchise agreements have provisions that limit certain decision-making rights of the equity investor(s) in the franchisee. Do those provisions result in a franchisee being considered a VIE under ASC subparagraph 810-10-15-14(b)(1)(i)?

Interpretive Response: When evaluating whether the holders of equity at risk have the power to make the decisions that most significantly impact a franchisee’s economic performance, it is important to determine whether the limitations imposed by the franchisor on the decision-making rights of the franchisee investor(s) are necessary to protect the franchisor’s brand. In a
typical franchise arrangement, the franchisor is effectively licensing its brand to the franchisee for a specified period of time and therefore is likely to require certain decision-making rights to ensure that the level of quality associated with the franchisor’s brand is maintained. These franchisor rights do not necessarily limit the franchisee investor’s power to make the decisions that most significantly impact the economic performance of the franchisee. For example, a franchise agreement may allow the franchisor to participate in the following decisions (not intended to be all-inclusive):

- The right to approve the location of the retail facility or geographic area in which the franchisee is permitted to operate;
- The right to require equipment, signs, menuboards, supplies, and other items necessary in connection with adding new approved products to be acquired, installed, and used at the retail facility as soon as possible consistent with franchisor requirements;
- The right to approve the products that may be sold at the retail facility;
- The right to approve suppliers for purchases of inventory, advertising materials, training materials, uniforms, packaging, computer hardware, insurance, and all food and beverage ingredients and products;
- The right to approve the days and hours of operation;
- The right to approve the franchisee’s marketing plan;
- The right to approve relocation of a retail facility; and
- The right to approve a sale of the franchise.

Although many of these decisions are important to the economic performance of the franchisee, the franchisor’s ability to participate in those decisions would not necessarily result in the equity group lacking the characteristic in ASC subparagraph 810-10-15-14(b)(1)(i). By entering into a franchise agreement, a franchisee has made a unilateral decision to operate its business in a specific location under a common trademark and system, and at the same time to adopt the franchisor’s business standards. The franchisor’s right to enforce its business standards does not necessarily cause a franchisee to be a variable interest entity. The condition in ASC subparagraph 810-10-15-14(b)(1)(i) would not be met if the equity group of the franchisee maintains control over decisions that most significantly impact the economic performance of the franchisee and these decisions are substantive in nature (i.e., they have a direct effect on revenues, expenses, gains, losses, etc.). Additionally, we believe that the equity group must have decision-making ability over areas that are not included in the franchise agreement. These would typically include control over the day-to-day operations of the franchise, including, but not limited to hiring, firing, and supervising of management and employees; establishing what prices to charge for products or services; and making capital
decisions of the franchise. Also, control over such fundamental decisions as
the form (corporate, LLC, LLP, partnership, etc.) of the franchisee, its charter,
how it is capitalized, etc., may also be important to the economic performance
of the franchisee, although if formed as a limited partnership or similar entity it
would be evaluated under ASC subparagraph 810-10-15-14(b)(1)(ii) (see
guidance beginning at paragraph 4.2.50.120).

In some situations, the franchisor may provide financial support to the
franchisee or the franchisee investor’s obligation to absorb expected losses or
receive expected residual returns of the franchisee is limited. In those
situations, the power to make the decisions that most significantly impact the
economic performance of the franchisee becomes increasingly important to the
franchisor because of the additional risk borne by the franchisor. Although the
level of equity as compared to expected losses may mitigate the additional risk
of the franchisor, in some instances the franchisor will require the franchisee to
provide the franchisor the right to make all decisions that have a significant
effect on the economic performance of the franchisee. In those instances, the
condition in ASC subparagraph 810-10-15-14(b)(1)(i) would be met and, as a
result, the franchisee would be a VIE. However, in other situations, the
franchisor may require the franchisee to relinquish some, but not all, of its
ability to make those decisions that have a significant effect on the franchisee’s
economic performance. In those situations, all facts and circumstances should
be considered in determining whether the condition in ASC subparagraph 810-
10-15-14(b)(1)(i) is met. The level of the franchisee’s equity compared to its
expected losses may be a particularly telling indicator as to whether this
condition is met. Also, the franchisee may lack a sufficient equity investment at
risk under ASC subparagraph 810-10-15-14(a) and thus be a variable interest
entity regardless of whether or not the condition in ASC subparagraph 810-10-
15-14(b)(1)(i) is met.

Example 4.2.50.2: Multi-Seller Commercial Paper Conduit

Description of the Arrangement

Entity ABC is a multi-seller commercial paper conduit. Various entities transfer
interest-bearing trade accounts receivable, notes receivable, or loans
receivable to ABC, and it simultaneously issues commercial paper to pay the
transferors for the financial assets. ABC’s only equity interest is approximately
10 basis points of its initial total capital (including the commercial paper). The
holder of that equity interest is not a related party of any of the transferors. The
return on the equity investment represents a fee paid to facilitate the existence
of the structure.

The parties involved with the commercial paper conduit include:

(1) The entities that transferred the financial assets (the transferors);
(2) An entity that places and services the commercial paper, provides a back-up letter of credit, a liquidity letter of credit, and a second loss guarantee (the administrator);

(3) The holder of the equity interest; and

(4) The holders of the commercial paper issued by the conduit.

Additional information about each of the parties is as follows:

**The Transferors:**

The transferors receive $0.90 for each $1 dollar of financial assets transferred. Each transferor also obtains the right to any excess of the ultimate collections on the financial assets it transferred over the amount necessary to repay the commercial paper obligation and a proportionate share of the conduit’s expenses. That excess is referred to as excess collateral on the commercial paper. Each transferor is obligated to service the financial assets it transferred. Each transferor’s rights and obligations relate to only the assets it transferred and no single transferor transfers into ABC a majority of its total assets. The transferors have no risk of loss or right to benefits related to assets transferred by other transferors and no obligation to transfer additional assets under any circumstance.

**The Administrator:**

The administrator decides which receivables to buy, the level of excess collateral required from each transferor, and the monitoring fee that will be charged to each transferor. It also places the commercial paper with investors and makes the required payments, pays the expenses of the conduit, reports to the transferors and equity investor, and provides other necessary administrative services in exchange for an incremental administrative fee. In addition, the administrator provides a standby letter of credit or line of credit, a liquidity letter of credit, and a second loss guarantee. All of the administrator’s fees are commensurate with those in other similar structures in the marketplace.

**The Holder of the Equity Interest:**

The holder of the equity interest receives a fee for facilitating the existence of the entity.

**The Holders of the Commercial Paper:**

The holders of the commercial paper have the right to receive specified amounts of cash at specified times. Because of the excess collateral and various other forms of credit risk protection, the holders bear very little risk and, consequently, receive a relatively low rate of return.

**Evaluation**

ABC is a VIE. The equity participant lacks sufficient decision-making rights given the broad powers of the administrator and, therefore, the condition in
Example 4.2.50.3: Investment Advisory Entities Designed to Comply with the Risk Retention Rules

Description of the Arrangement

Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act required the SEC and other regulators to prescribe rules requiring many sponsors of securitizations of asset-backed securities (ABS) to retain a portion of the credit risk of the assets collateralizing the asset-backed securities. Unless an exemption applies, under the Risk Retention Rules, sponsors of securitizations that issue ABS must retain an eligible horizontal residual interest (as defined in the rules), or an eligible vertical interest (as defined by the rules), or a combination of both.

In some situations a reporting enterprise (the founding enterprise) may create an investment advisory entity, referred to as a Capitalized Manager Vehicle (CMV), to sponsor a securitization of ABS under the Risk Retention Rules. The CMV may be created for a variety of reasons, including to address capital adequacy considerations applicable to founding enterprises that are financial institutions (i.e., the required retained interests under the Risk Retention Rules may negatively affect certain capital adequacy tests) by eliminating the founding enterprise's role as the sponsor of the securitization. Although each CMV may have its own unique characteristics and reporting enterprises may have different economic interests in CMVs they are involved with, we understand that some CMVs and involvement with CMVs by a founding enterprise have the following characteristics.

- The CMV is entirely equity capitalized largely by parties unrelated to the founding enterprise with no individual investor owning more than 25% of the CMV's equity. All equity investments are classified by the CMV as permanent equity and the total equity investment at risk is sufficient to finance the CMV's activities without additional subordinated financial support;

- The founding enterprise holds no more than 10% of the CMV's equity and is not committed to make any future investments in the CMV;

- All significant operating and capital decisions of the CMV are controlled by majority vote of the entity's board of directors comprising a majority of individuals selected by parties unrelated to the founding enterprise;

- Day-to-day activities of the CMV are conducted by an investment committee appointed by and subject to removal by majority vote of the CMV's board of directors. Although employees of the founding enterprise may serve on the investment committee, the investment...
committee will solely be responsible for carrying out the decisions reached by the CMV’s board of directors;

- Certain personnel, credit analysis, loan management, middle office, back office, and other services may be provided by the founding enterprise subject to the ongoing approval of a majority of the CMV’s board of directors. The founding enterprise will receive a percentage of the fixed management fee earned by the CMV on securitizations of ABS the CMV sponsors and manages; and
- The CMV is expected to invest in ABS issued by securitizations it sponsors and manages to comply with the Risk Retention Rules.

Evaluation

Although each reporting enterprise will need to evaluate a CMV or similar entity it is involved with based on its specific facts and circumstances, the staff from the SEC’s Office of the Chief Accountant (SEC staff) did not object to a founding enterprise registrant’s conclusion to not consolidate a CMV it created with the characteristics described above. The SEC staff confirmed this conclusion in a speech by Christopher Rickli delivered at the 2015 AICPA National Conference on Current SEC and PCAOB Developments.

We understand that the SEC staff did not object to the registrant’s conclusions as follows:

- The CMV is not the functional equivalent of a limited partnership;
- The CMV’s total equity investment at risk is sufficient to permit the CMV to finance its activities without additional subordinated financial support;
- The holders of the CMV’s equity investment at risk have the power through voting rights to direct the activities that most significantly affect the CMV’s economic performance;
- The CMV has none of the other characteristics of a variable interest entity (VIE) in ASC paragraph 810-10-15-14;
- The CMV is not considered a VIE and should be evaluated for consolidation using the guidance in ASC paragraph 810-10-15-8, which indicates that the usual condition for a controlling financial interest is ownership of a majority voting interest; and
- As the founding enterprise in the facts described above does not hold a majority voting interest (i.e., does not control a majority of the CMV’s board of directors) the founding enterprise should not consolidate the CMV and should apply the equity method of accounting to its investment in the CMV.

Based on informal discussions with the SEC staff, we understand factors considered in reaching this conclusion included:
The significant investment by third-party investors and limited investment by the founding enterprise (i.e., 10% or less of the CMV's equity);

- The existence of a board of directors controlled by parties unrelated to the founding enterprise that controls the actions of the investment committee, including setting the investment strategy;

- The activities undertaken by the founding enterprise are limited to administrative activities subject to ongoing approval by a majority of the CMV's board of directors; and

- The founding enterprise has no explicit or implicit commitment to make additional investments in the CMV.

As the Risk Retention Rules are adopted, we expect that this structure and others will be considered by reporting enterprises that are currently sponsors of securitizations of ABS.

LIMITED PARTNERSHIPS AND SIMILAR ENTITIES

4.2.50.120. The FASB decided with the issuance of ASU 2015-02 to change the VIE criteria so that regardless of the sufficiency or other characteristics of its equity, a limited partnership or similar entity is a VIE unless substantive kick-out rights or participating rights are exercisable by either a single limited partner or a simple majority of all limited partner voting interests excluding those held by the general partner, entities under common control with the general partner, and other parties acting on behalf of the general partner. The analysis of whether a limited partnership or similar entity is a VIE is therefore no longer affected by whether the general partner interest qualifies as an equity-at-risk interest.

4.2.50.130. Entities for which investors are eligible to apply the pro-rata method of consolidation based on industry practice in the construction industry or extractive industries are outside the scope of this provision. This allows investors in these entities to continue to apply the pro-rata method of consolidation when applicable.

Question 4.2.50.16: Evaluating Kick-Out Rights When the General Partner or Its Related Parties Hold Limited Partner Interests

How are simple majority kick-out rights calculated when the general partner, entities under common control with the general partner, or other parties acting on behalf of the general partner hold a limited partner interest?

**Background:** For a limited partnership, kick-out rights held by the general partner, entities under common control with the general partner, or other parties acting on behalf of the general partner are not included for purposes of evaluating whether a simple majority or lower threshold of limited partners with equity at risk have substantive kick-out rights (ASC subparagraph 810-10-15-14(b)(1)(ii)).
**Interpretive Response:** When the general partner, parties under common control with the general partner, or other parties acting on behalf of the general partner hold a limited partner interest, the denominator in the simple majority calculation is affected. The formula to calculate whether a simple majority or lower threshold is required to kick out the general partner without cause is:

\[
\text{Limited partner voting interests required to kick out the general partner} + \frac{\text{Total limited partner voting interests} - \text{limited partner voting interests held by general partner} - \text{limited partner voting interests held by parties under common control with general partner} - \text{limited partner voting interests held by other parties acting on behalf of the general partner}}{\text{Total limited partner voting interests}}
\]

The following examples illustrate the calculation.

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**Example 4.2.50.4: General Partner Does Not Hold a Limited Partner Interest**

A limited partnership has 100 limited partners that collectively hold all of the partnership’s limited partner interests. Each limited partner receives voting interests equal to the limited partner’s percentage share of the total limited partner interests. Based on the partnership agreement, the limited partners may kick out the general partner without cause based on a simple majority of the limited partner voting interests. None of the limited partners are under common control with the general partner or acting on behalf of the general partner. The general partner also does not hold any limited partner interests. The limited partners do not have substantive participating rights.

In this example, the limited partners have a simple majority kick-out right, calculated as \((51 \div [100 – 0])\). Presuming the kick-out rights meet the other conditions to be considered substantive, the limited partners would have the power through voting rights or similar rights to direct the activities that most significantly impact the partnership’s economic performance (ASC subparagraph 810-10-15-14(b)(1)(ii)). If none of the other criteria are met for the partnership to be a VIE, the partnership would be a voting interest entity.

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**Example 4.2.50.5: General Partner Holds a Limited Partner Interest**

Modifying the facts in Example 4.2.50.4, assume the general partner holds 10% of the limited partner interests.

Kick-out rights held by the general partner are excluded when evaluating whether the limited partners hold simple-majority kick-out rights. In this example, approval of 57% \((51 \div [100 – 10])\) of the limited partner voting interests, excluding interests held by the general partner, parties under common control with the general partner, or other parties acting on behalf of the general partner is required to kick out the general partner without cause. Because this is more than a simple majority, the limited partners lack the power through voting rights or similar rights to direct the activities that most
significantly impact the partnership’s economic performance. Therefore, the partnership is a VIE.

4.2.50.140. ASC Subtopic 810-10 also includes the following implementation guidance in assessing whether the limited partners hold simple majority kick-out rights.

**Excerpt from ASC Subtopic 810-10**

**Example 3: Simple Majority Threshold for the Application of Kick-Out Rights**

This Example illustrates the guidance in paragraph 810-10-15-14(b)(1)(ii). Cases A, B, C, F, and G illustrate arrangements in which the limited partnership agreement requires a simple majority vote of the limited partnership’s kick-out rights through voting interests to remove the general partner and the general partner cannot vote. Cases D and E demonstrate arrangements in which the limited partnership agreement requires a two-thirds vote and a unanimous vote, respectively, of the limited partnership’s kick-out rights through voting interests to remove the general partner and the general partner cannot vote. To illustrate the application of the thresholds to exercise kick-out rights through voting interests for limited partnerships in paragraph 810-10-15-14(b)(1)(ii)(01), consider the following cases:

**Case A: Three Equal-Interest Limited Partners**

Assume that a limited partnership has 3 limited partners, none of which have any relationship to the general partners, and that each holds an equal amount of the limited partnership’s kick-out rights through voting interests (33.33 percent). In this Case, applying the simple majority requirement in the partnership agreement would require a vote of no more than two of the three limited partners to remove the general partners. Presuming the kick-out rights are substantive, a limited partnership that entitles any individual limited partner to remove the general partner or a limited partnership that requires a vote of two of the limited partners to remove the general partner would not meet the condition in paragraph 810-10-15-14(b)(1)(ii), meaning the partners would not lack the power through voting rights or similar rights to direct the activities of the partnership that most significantly impact the partnership’s economic performance. Therefore, assuming none of the other criteria in paragraph 810-10-15-14 are met for the limited partnership to be considered a variable interest entity (VIE), the limited partnership would be considered a voting interest entity. However, if a vote of all three limited partners is required to remove the general partner and the limited partners do not possess substantive participating rights, the limited partnership would meet the condition in paragraph 810-10-15-14(b)(1)(ii) because the required vote is more than a simple majority of the limited partnership’s kick-out rights through voting interests. Accordingly, the limited partnership would be considered a VIE.
Case B: Two Equal-Interest Limited Partners

55-4P Consider the same facts as in Case A, except that there are two limited partners that each hold an equal amount of the limited partnership’s kick-out rights through voting interests. In this Case, a simple majority of the limited partnership’s kick-out rights through voting interests would require a vote of both limited partners. Presuming the kick-out rights are substantive, a limited partnership entitling any individual limited partner to remove the general partner or a limited partnership that requires a vote of both limited partners to remove the general partner would not meet the condition in paragraph 810-10-15-14(b)(1)(ii), meaning the partners would not lack the power through voting rights or similar rights to direct the activities of the partnership that most significantly impact the partnership’s economic performance. Therefore, assuming none of the other criteria in paragraph 810-10-15-14 are met for the limited partnership to be considered a VIE, the limited partnership would be considered a voting interest entity.

Case C: One Hundred Equal-Interest Limited Partners

55-4Q Consider the same facts as in Case A, except that there are 100 limited partners that each hold an equal amount of the limited partnership’s kick-out rights through voting interests. In this Case, a simple majority of the limited partnership’s kick-out rights through voting interests would require a vote of 51 limited partners. Presuming the kick-out rights are substantive, a limited partnership that requires a vote of less than 52 limited partners to remove the general partner would not meet the condition in paragraph 810-10-15-14(b)(1)(ii), meaning the partners would not lack the power through voting rights or similar rights to direct the activities of the partnership that most significantly impact the partnership’s economic performance. Therefore, assuming none of the other criteria in paragraph 810-10-15-14 are met for the limited partnership to be considered a VIE, the limited partnership would be considered a voting interest entity. However, if a vote of 52 or more limited partners is required to remove the general partner and the limited partners do not possess substantive participating rights, that limited partnership would meet the condition in paragraph 810-10-15-14(b)(1)(ii) because the required vote is more than a simple majority of the limited partnership’s kick-out rights through voting interests. Accordingly, the limited partnership would be considered a VIE.

Case D: Required Limited Partner Voting Percentages of More Than a Simple Majority

55-4R In this Case, consider the following situations based on a limited partnership agreement that requires a vote of 66.6 percent of the limited partnership’s kick-out rights through voting interests to remove the general partner:
Case D1: Equal-Interest Limited Partners

55-4S There are 3 independent limited partners (none of which have any relationship to the general partner) that each hold an equal percentage (33.33 percent) of the limited partnership’s kick-out rights through voting interests. A vote of 2 of the 3 limited partners represents 66.7 percent of the limited partnership’s kick-out rights through voting interests, which also represents the smallest possible combination that is at least a simple majority of the limited partnership’s kick-out rights through voting interests. Presuming the kick-out rights are substantive, the limited partnership would not meet the condition in paragraph 810-10-15-14(b)(1)(ii), meaning the partners would not lack the power through voting rights or similar rights to direct the activities of the partnership that most significantly impact the partnership’s economic performance. Therefore, assuming none of the other criteria in paragraph 810-10-15-14 are met for the limited partnership to be considered a VIE, the limited partnership would be considered a voting interest entity.

Case D2: Limited Partners with Unequal Interests

55-4T There are 3 independent limited partners (none of which have any relationship to the general partner) that hold 45 percent (Limited Partner 1), 25 percent (Limited Partner 2), and 30 percent (Limited Partner 3) of the limited partnership’s kick-out rights through voting interests respectively. To remove the general partners, a vote of Limited Partner 1 in combination with either Limited Partner 2 or Limited Partner 3 would be a simple majority of the limited partnership’s kick-out rights through voting interests and would satisfy the 66.6 percent contractual requirement. In contrast, a vote to exercise the kick-out right by Limited Partner 2 and Limited Partner 3 also would represent a simple majority of the limited partnership’s kick-out rights through voting interests; however, their kick-out rights (55 percent) would not meet the required threshold of 66.6 percent to remove the general partners. Accordingly, assuming the limited partners do not possess substantive participating rights, the limited partnership would meet the condition in paragraph 810-10-15-14(b)(1)(ii), meaning the partners would lack the power through voting rights or similar rights to direct the activities of the partnership that most significantly impact the partnership’s economic performance because the smallest possible combination (Limited Partner 2 and Limited Partner 3) that represents at least a simple majority of the limited partnership’s kick-out rights through voting interests cannot remove the general partners. Accordingly, the limited partnership would be considered a VIE.

Case E: Four Equal-Interest Limited Partners with a Required Unanimous Vote of the Limited Partnership’s Kick-Out Rights through Voting Interests

55-4U Assume that there are 4 independent limited partners (none of which have any relationship to the general partner) that each own 10 percent of the equity of the limited partnership in the form of limited partnership voting interests. The general partner owns 60 percent of the equity of the limited
partnership and does not have kick-out rights through voting interests. The limited partners have kick-out rights through voting interests, but the limited partners must vote unanimously to kick out the general partner. Assuming the limited partners do not possess substantive participating rights, the limited partnership would meet the condition in paragraph 810-10-15-14(b)(1)(ii), meaning the partners would lack the power through voting rights or similar rights to direct the activities of the partnership that most significantly impact the partnership’s economic performance because more than a simple majority of kick-out rights through voting interests is required to remove the general partner. Accordingly, the limited partnership would be considered a VIE.

Case F: Limited Partner and General Partner with a Required Simple Majority Percentage of the Limited Partnership’s Kick-Out Rights through Voting Interests—Limited Partner Consolidates

55-4V Assume that there is an independent limited partner (who does not have any relationship with the general partner) that holds 40 percent of the equity of the limited partnership in the form of limited partnership voting interests. The general partner owns 60 percent of the equity of the limited partnership and does not have kick-out rights through voting interests. The limited partner has kick-out rights through voting interests, and a vote of a simple majority of the kick-out rights through voting interests to remove the general partner is required. Therefore, presuming the kick-out rights are substantive, the limited partnership would not meet the condition in paragraph 810-10-15-14(b)(1)(ii), meaning the partners would not lack the power through voting rights or similar rights to direct the activities of the partnership that most significantly impact the partnership’s economic performance because the single limited partner is able to exercise the kick-out rights unilaterally. Assuming none of the other criteria in paragraph 810-10-15-14 are met for the limited partnership to be considered a VIE, the limited partnership would be considered a voting interest entity. Accordingly, the limited partner that holds 40 percent of the equity of the limited partnership in the form of limited partnership voting interests would be deemed to have a controlling financial interest in the limited partnership on the basis of the guidance in paragraph 810-10-25-1A.

Case G: Four Equal-Interest Limited Partners with a Required Simple Majority Percentage of the Limited Partnership’s Kick-Out Rights through Voting Interests—No Partner Consolidates

55-4W Assume that there are 4 independent limited partners that each own 10 percent of the equity of the limited partnership in the form of limited partnership voting interests. The general partner owns 60 percent of the equity of the limited partnership and does not have kick-out rights through voting interests. The limited partners have kick-out rights through voting interests, and a vote of a simple majority of the kick-out rights through voting interests to remove the general partner is required. Therefore, presuming the kick-out rights are substantive, the limited partnership would not meet the condition in paragraph 810-10-15-14(b)(1)(ii), meaning the partners would not lack the power through voting rights or similar rights to direct the activities of the partnership that most
significantly impact the partnership’s economic performance. Assuming none of the other criteria in paragraph 810-10-15-14 are met for the limited partnership to be considered a VIE, the limited partnership would be considered a voting interest entity. Accordingly, no partner would be deemed to have a controlling financial interest in the limited partnership on the basis of the guidance in paragraph 810-10-25-1A because no single limited partner owns a majority of the limited partnership’s kick-out rights through voting interests. Therefore, no partner consolidates the limited partnership.

**Question 4.2.50.17: Nominal Investment by the General Partner of a Limited Partnership**

If the amount of the general partner’s equity investment in a limited partnership is nominal, is it relevant in evaluating whether the limited partnership meets the condition in ASC subparagraph 810-10-15-14(b)(1)(ii)?

**Background:** An investor’s equity investment must be substantive for it to be considered at risk under the provisions of ASC subparagraph 810-10-15-14(a). A nominal investment generally would not be considered substantive.

**Interpretive Response:** No. Because ASU 2015-02 changes how limited partnerships and similar entities are evaluated under ASC subparagraph 810-10-15-14(b)(1)(ii), the analysis of the power characteristic is no longer affected by whether the general partner interest qualifies as an equity-at-risk interest. The evaluation of power is now solely based on whether substantive kick-out rights or participating rights are exercisable by either a single limited partner or a simple majority of all limited partner voting interests, excluding limited partner voting interests held by the general partner, entities under common control with the general partner, and other parties acting on behalf of the general partner.

**Question 4.2.50.18: Kick-Out Rights and Participating Rights**

Are there differences in how kick-out rights and participating rights are evaluated for corporations versus limited partnerships and similar entities in determining whether the equity-at-risk investors as a group have power to direct the activities that most significantly affect an entity’s economic performance?

**Interpretive Response:** Yes. In evaluating whether the equity-at-risk investors as a group have power to direct the activities that most significantly affect the economic performance of entities other than limited partnerships, a reporting enterprise should use the VIE definition of kick-out rights and participating rights. Conversely, when evaluating whether the equity-at-risk investors as a group have power to direct the activities that most significantly affect the economic performance of limited partnerships and similar entities, a reporting
enterprise should use the voting interest entity definition of kick-out rights and participating rights.

The VIE definition of kick-out rights is closely aligned with the voting interest entity definition of kick-out rights, because the Board decided in ASU 2015-02 that liquidation rights are equivalent to kick-out rights in the VIE definition. However, the VIE and voting interest entity definitions of participating rights differ in important respects. In accordance with the VIE definition, participating rights relate to 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, while the voting interest entity definition of participating rights focuses on certain significant financial and operating decisions that are made in the ordinary course of business.

Rights in the ordinary course of business may also represent participating rights for legal entities other than limited partnerships if the activities subject to these powers most significantly impact the VIE’s economic performance. This is more likely to be true for VIEs with substantive ongoing business operations than for other VIEs. However, all facts and circumstances should be considered, including the level at which these powers operate. For example, the ability to approve operating and capital budgets may not remove power from the servicer of a collateralized financing entity VIE if significant decisions about default mitigation cannot be significantly influenced through the budget process. Ultimately, a substantive participating right for a legal entity other than a limited partnership must provide the holder the right to participate in making the decisions that most significantly impact the VIE’s economic performance.

4.2.60. Obligation to Absorb Expected Losses

4.2.60.10. An entity’s equity participants as a group must be exposed to the entity’s economic risks (referred to in ASC Section 810-10-15 as expected losses) in the same way that a true residual interest is exposed to the economic risks of the entity. Holders of the equity investments at risk must bear the exposure to the first dollar risk of loss in the entity; sharing that exposure with non-equity investors is not permitted. If equity participants are directly or indirectly protected from incurring the expected losses of the entity either by the entity itself or by other parties involved with the entity, the entity will be considered a VIE.

4.2.60.20. Entities are not required to perform a quantitative analysis when determining whether holders of the equity investments at risk are shielded from expected losses, as a qualitative evaluation may be more effective. If a qualitative assessment is performed, entities should consider the nature and terms of any contractual agreements that its variable interest holders have between each other and with the entity itself that may shield the equity-at-risk group from expected losses. Qualitative assessments may entail understanding the attribution of cash flows to the entity’s various interest holders to see whether the equity investors would absorb the first dollar of loss. If a qualitative
assessment indicates that there are no interests that (1) are subordinate to the equity at risk, (2) protect equity investors, or (3) guarantee the value of an entity’s assets or the investors a return, the analysis would be sufficient under ASC subparagraph 810-10-15-14(b)(2).

4.2.60.30. Common arrangements that may protect equity participants from the first dollar risk of loss include, but are not limited to:

- Residual value guarantee of an entity’s assets that comprise more than 50% of the fair value of the entity’s total assets;
- Agreement to purchase an entity’s specified assets that comprise more than 50% of the fair value of the entity’s total assets;
- Arrangements that allocate an entity’s cash flows in a manner that protects equity investors from the risk of loss (e.g., the entity’s cash flow waterfall allocates cash inflows to subordinate equity interests first);
- Credit enhancements for assets of the entity;
- Guarantees of an entity’s debt (if equity investors are shielded from losses);
- Reimbursements to the entity or its equity investors for losses; and
- Contractual arrangements to purchase the majority of an entity’s goods or services on a cost-plus basis (e.g., actual costs to produce the goods or render the services plus a profit margin). If the cost of purchasing the goods or services exceeds their fair value, then the purchaser may be providing the entity with a form of subordinated financial support. Cost-plus purchase contracts should be evaluated to determine whether they protect the at-risk equity group from the first dollar of loss.

4.2.60.40. The exposure of variable interests other than equity interests to expected losses of an entity may not be considered in determining whether the entity’s at-risk equity investors have the obligation to absorb the entity’s expected losses, even if the other variable interests are held or issued by an equity investor. Additionally, sharing expected losses with non-equity interest holders would result in the entity being considered a VIE because, by design, the holders of the equity investment at risk cannot be shielded from the risk of loss on any portion of their investment by the entity itself, or by others that are involved with the entity. This is because of the notion that when parties other than the equity investors are exposed to the entity’s expected losses, voting interests become less relevant in identifying the parties that may have control over the entity’s activities.

4.2.60.50. However, there is an exception to this rule. Guarantees or other arrangements that pertain to specific assets of an entity are not deemed to protect the equity participants from absorbing the entity’s expected losses as
long as the specified assets represent less than 50% of the fair value of the entity’s total assets.

**Example 4.2.60.1: Expected Losses Absorbed by Non-Equity Interests**

**Background**

Assume three investors (Investors 1, 2, and 3) form a venture by each contributing $1,000 at inception in exchange for equity interests. Based on an evaluation of the guidance in ASC subparagraph 810-10-15-14(a), all equity contributed is considered at risk. The venture uses its capital to purchase a fixed income investment grade bond for $1,700. In addition, assume that in exchange for a $250 premium, Investor 3 also agrees to guarantee that the value of the bond will be at least $1,700 if it is sold within the next five years, which is the maximum life of the venture.

**Evaluation**

While all expected losses will be absorbed by a member of the equity-at-risk group in the example above (because of the guarantee held by Investor 3), the entity is a VIE because the expected losses are absorbed by a non-equity-at-risk interest (i.e., the guarantee).

**Revised Facts**

Assume that Investor 3 did not enter into the guarantee arrangement in the example above. Instead, the venture entered into a total return swap with a bank whereby the venture will pay 80% of the total return on the fixed-rate bond in exchange for a LIBOR indexed return.

**Evaluation**

In this example, the at-risk equity investors are shielded from 80% of any losses on the fixed-rate bond. For instance, if the value of the bond declined by $1, the bank would absorb $0.80 and the equity investors would absorb $0.20 of the losses. In substance, the arrangement would result in the bank shielding the equity investors from $0.80 of the first dollar risk of loss, which would result in the condition in ASC subparagraph 810-10-15-14(b)(2) being met and the entity being considered a VIE.

**Example 4.2.60.2: Obligation to Absorb Expected Losses**

**Example A:** A lessor trust issues $3 of equity and $97 of nonrecourse debt and uses the proceeds to purchase equipment with a fair value of $100. To protect against unexpected declines in the value of the equipment, the lessee is required to provide a residual value guarantee that the value of the equipment will be at least $80 at the end of the five-year lease term. At the end of the lease term, the unamortized balance on the nonrecourse debt is expected to be $78.
Evaluation

In this example, the equity participants are not obligated to absorb the expected losses of the entity because they are protected by the residual value guarantee and the unamortized amount of the nonrecourse debt. The equity participants cannot lose more than $1 (combined unamortized nonrecourse debt balance and equity less the amount of the residual value guarantee) of their investment unless the lessee fails to honor the guarantee.

Guarantees that protect an entity’s creditors would not cause the entity to be a VIE, provided the guarantees do not protect the equity participants from incurring a complete loss of their investment. If the residual value guarantee only provided assurance that the residual value of the equipment would be at least $78, up to a maximum exposure of $50 (i.e., the value is guaranteed between $28 and $78), the guarantee would not protect the equity participants from expected losses. Therefore, the entity would not be a VIE.

Example B: BW Holdings (BW) leases a tract of farmland worth $100 million to RGH Farming (RGH) for a term of seven years. BW finances its acquisition of the farmland by issuing $75 million of debt and $25 million of equity, all of which is considered at risk. The equity investors have all control over decisions and are not constrained from selling their interests. RGH also wrote a put option that permits BW to sell the farmland to RGH at the conclusion of the lease for 95% of the farmland’s fair value at inception ($95 million).

Evaluation

Because the put option will limit the losses that will be absorbed by the equity investors to $5 million ($100 million purchase price less the $95 million fair value guarantee provided by the put option), BW is a VIE under ASC subparagraph 810-10-15-14(b)(2).

Example C: Assume that the put option in Example B does not exist. Instead RGH guarantees that the farmland will be worth $5 million at the end of the lease (5% of the fair value upon inception).

Evaluation

In this scenario, the at-risk equity group is not shielded from any losses on the fair value of the farmland. Equity investors would suffer a complete loss if the fair value declined by $25 million at the end of the lease. The guarantee would protect the debt holders from realizing a complete loss, as they would be able to recoup $5 million via the guarantee if the farmland was deemed to be worthless. As such, BW would not be considered a VIE under ASC subparagraph 810-10-15-14(b)(2).

Example D: Assume that neither the put option in Example B nor the guarantee in Example C exists. Instead, RGH writes a put option allowing the debt holders to sell the farmland to it for $50 million in the event of foreclosure.
Evaluation
Consistent with Example C, only the debt holders would be shielded from losses. Because the put option would only be effective if the equity interests were deemed to be worthless, the at-risk equity group would not be shielded from expected losses in this scenario. Accordingly, RGH would not be considered a VIE under ASC subparagraph 810-10-15-14(b)(2).

Question 4.2.60.1: Customary Business Arrangements Absorb Risk of Loss

Would an entity be considered a VIE under ASC subparagraph 810-10-15-14(b)(2) if it entered into customary business arrangements that would protect the at-risk equity group from the risk of loss?

Interpretive Response: The guidance in ASC subparagraph 810-10-15-14(b)(2) was developed to identify structures designed to protect the at-risk equity group from losses resulting from the risks the entity was designed to create and distribute to its variable interest holders and structures where the equity investments lack economic substance. While certain routine business arrangements (e.g., property and casualty or business interruption insurance) shield the at-risk equity group from an entity’s losses, we do not believe that this, by design, would result in an entity being considered a VIE. An arrangement’s terms should be carefully evaluated to identify whether it shields equity investors from the first dollar risk of loss. Derivatives transferring all or substantially all of an entity’s variability to the counterparty are generally not considered customary hedging transactions. The following example illustrates this concept:

Background
KKB Farming (KKB) is a publicly traded soybean and blueberry farmer and distributor. For risk management purposes, KKB purchases property and casualty insurance and business interruption insurance. It also enters into fixed-price forward contracts with buyers for 55% of its expected crop output to protect against declining soybean and blueberry prices.

Evaluation
KKB is not a VIE merely because it implemented risk management programs designed to protect against potential losses. As stated above, we believe that the guidance in ASC subparagraph 810-10-15-14(b)(2) is intended to identify entities that, by design, protect the at-risk equity group from losses that it was designed to create and distribute to its equity interest holders. As such, we do not believe that KKB’s risk management activities would result in it being considered a VIE under ASC subparagraph 810-10-15-14(b)(2). Enterprises must exercise
judgment when determining whether, by design, the at-risk equity group is being shielded from losses.

**Question 4.2.60.2: Disproportionate Loss Sharing**

If the holders of an entity’s equity investment at risk share losses through their equity instruments in a manner that is disproportionate to their respective ownership percentages, would the entity be a VIE under ASC subparagraph 810-10-15-14(b)(2)?

**Interpretive Response:** No. Holders of an entity’s equity investment at risk may agree to share losses disproportionately to their respective ownership percentages because ASC subparagraph 810-10-15-14(b)(2) is applied to the at-risk equity group as a whole. This concept is demonstrated in the following example:

**Background**

Assume that the general partner of a real estate partnership, for which its interest is considered to be at risk under ASC subparagraph 810-10-15-14(a), is responsible for managing all activities of the limited partnership. The limited partners contribute capital, also considered at risk, share in the profits and losses, and have simple majority substantive participating rights. The equity at risk is considered sufficient under ASC subparagraph 810-10-15-14(a). While the general partner is responsible for partnership debts, the limited partners would not incur liabilities in excess of their capital contributions.

**Evaluation**

While the expected losses in this scenario are disproportionately allocated to the general partner, the condition in ASC subparagraph 810-10-15-14(b)(2) is not met because it is applied to the at-risk equity investors as a group. Entities are not required to absorb losses beyond their initial investments for the entity not to be considered a VIE. However, the anti-abuse guidance about disproportionality in ASC subparagraph 810-10-15-14(c) also must be evaluated before concluding that an entity is not a VIE.

**Example 4.2.60.3: Interests in Specified Assets**

**Background**

Assume a real estate partnership was formed to purchase and manage two industrial warehouses. The partnership is capitalized by debt of $80 million and equity of $20 million. All equity is considered at risk under ASC subparagraph 810-10-15-14(a). After it is formed, the partnership acquires two buildings (Warehouse 1 and Warehouse 2) for $55 million and $45 million, respectively.
The tenant of Warehouse 2 guarantees that the residual value of the property will be worth at least $45 million at the end of its 10-year lease.

Evaluation

Although the residual value guarantee shields the partnership’s equity investors from potential losses on Warehouse 2, it does not represent a variable interest in the partnership because the fair value of Warehouse 2 is less than 50% of the fair value of the partnership. Accordingly, the fact that the tenant absorbs expected losses of Warehouse 2 would not be considered when evaluating whether the at-risk equity group has the obligation to absorb expected losses. Therefore, the guarantee would not cause the condition in ASC subparagraph 810-10-15-14(b)(2) to be met.

Conversely, if the tenant of Warehouse 1 guaranteed the residual value of the property for $55 million upon the conclusion of the lease, then this would represent a variable interest in the entity as a whole because Warehouse 1 comprises more than 50% of the fair value of the partnership’s total assets. This residual value guarantee would shield the equity at risk group from expected losses and the entity would be a VIE under ASC subparagraph 810-10-15-14(b)(2).

4.2.70. Right to Receive Expected Residual Returns

4.2.70.10. The entity’s equity participants as a group must have the right to receive the entity’s economic rewards (referred to in ASC Subtopic 810-10 as expected residual returns), in the same way that a true residual interest has the right to receive the economic rewards of the entity. If, as a group, the equity participants’ right to receive the expected residual returns of the entity is capped by the entity’s governing documents or through arrangements with the entity or other variable interest holders outside the equity group, the entity is considered a VIE under ASC subparagraph 810-10-15-14(b)(3). The right to receive expected residual returns embodied in a variable interest other than an equity-at-risk interest may not be considered when determining whether the entity’s at-risk equity group has the right to receive the entity’s expected residual returns.

4.2.70.20. ASC Subtopic 810-10 provides very little guidance about the meaning of capped, and it may be difficult to determine in some circumstances whether an arrangement causes the equity participants’ right to receive the entity’s expected residual returns to be capped or instead simply results in the equity participants receiving less than 100% of the entity’s expected residual returns. ASC Subtopic 810-10 does indicate that the equity investors’ right to receive the entity’s expected residual returns is not considered to be capped by outstanding stock options, convertible debt, or similar interests in the entity. If the options in those instruments were exercised, the holders would become additional equity investors in the entity. Similarly, we believe that the equity participants’ right to receive the entity’s expected residual returns generally is not capped if some of the equity investors write a fixed-price call option for another party or parties to acquire some or all of the investors’ equity interests in the entity. A written fixed-
price call option on some, but not all, assets of the entity also generally would not represent a cap on the equity participants’ right to receive the entity’s expected residual returns. However, predetermined distribution arrangements that cap the residual returns of the entity allocated to the equity investors to a de minimis amount may result in an entity being considered a VIE under ASC subparagraph 810-10-15-14(b)(3).

4.2.70.30. Similar to evaluating whether the at-risk equity group has the obligation to absorb expected losses, qualitative assessments may be sufficient for determining whether the holders of equity investments at risk have the right to receive the entity’s expected residual returns. This evaluation may entail understanding the attribution of cash flows to the entity’s various interest holders (e.g., whether certain variable interest holders share in a large percentage of the entity’s cash flows relative to the total expected residual returns).

Example 4.2.70.1: Cap on the Right to Receive an Entity’s Expected Residual Returns

A lessor entity owns two leased manufacturing machines, Machine A, with an initial fair value of $75, and Machine B, with an initial fair value of $25. Both machines are leased to lessees under operating leases. At the end of the lease term for Machine A, the lessee has the right to exercise a purchase option to buy the machine for a fixed price of $50. Because the fair value of Machine A is greater than 50% of the fair value of the lessor’s total assets, the lessee’s purchase option with respect to Machine A is considered a variable interest in the lessor entity and must be considered in evaluating the conditions in ASC paragraph 810-10-15-14. If the value of Machine A is greater than $50 at the end of the lease term, the lessee would be able to benefit from the excess of the then-fair value over the fixed purchase price of $50. However, even though the equity participants’ right to receive the entity’s expected residual returns would be limited as a result of the purchase option, it would not be capped because there is no fixed price purchase option provided to the lessee of Machine B. As a result, the purchase option would not cause the condition in ASC subparagraph 810-10-15-14(b)(3) to be met.

Example 4.2.70.2: Profit-Sharing Arrangements between Equity Investors

Assume a venture is created by ABC (20% of equity) and DEF (80% of equity). Under the venture arrangement, profits are allocated based on each entity’s relative ownership percentage until DEF achieves an internal rate of return of 20% on its investment, at which point profits are then to be distributed to ABC and DEF at a rate of 80% and 20%, respectively. While this profit distribution may indirectly cap DEF’s return, the condition in ASC subparagraph 810-10-15-14(b)(3) would not be met because the holders of the equity investment at risk, as a group, receive the expected residual returns of the entity.
Example 4.2.70.3: Right to Receive Expected Residual Returns

Example A: BW Holdings (BW) leases a tract of farmland worth $100 million to RGH Farming (RGH) for a term of seven years. BW finances its acquisition of the farmland by issuing $75 million of debt and $25 million of equity, all of which is considered at risk. The equity investors have all control over decision making and are not constrained from selling their interests. RGH has the option to purchase the farmland at a fixed price ($100 million) at the end of the lease term.

Evaluation
The fixed price purchase option caps the expected residual returns of the equity investors; accordingly, BW is a VIE under ASC subparagraph 810-10-15-14(b)(3).

Example B: CKW Healthcare (CKW) is a publicly traded hospital network in the Northeast. To attract the most qualified doctors, CKW has an employee profit-sharing plan that provides its employees up to 5% of its annual net income.

Evaluation
While CKW’s profits are shared with non-equity investors under the terms of its employee profit-sharing program, the condition in ASC subparagraph 810-10-15-14(b)(3) is not met because this arrangement does not cap the returns of the holders of the equity investments at risk. Entities should evaluate the specific terms of the arrangement to ascertain whether, by design, the returns of the at-risk equity group are capped.

Example C: Assume three investors (Investors 1, 2, and 3) form an investment partnership by each contributing $1,000 at inception in exchange for equity interests. Based on an evaluation of the guidance in ASC subparagraph 810-10-15-14(a), all equity contributed is considered at risk. The partnership hires an investment advisor to make all decisions relative to the purchase and sale of its investments. For its services, the investment advisor receives a fixed fee of $100 each month in addition to any of the partnership’s monthly profits that exceed $10,000.

Evaluation
Because the fee arrangement caps the at risk equity investors’ returns to $10,000 per month, the investment partnership is a VIE under ASC subparagraph 810-10-15-14(b)(3).
Example 4.2.70.4: Expected Residual Returns Received by Non-Equity Interests

Background

Assume three investors (Investors 1, 2, and 3) form a venture by each contributing $1,000 at inception in exchange for equity interests. Based on an evaluation of the guidance in ASC subparagraph 810-10-15-14(a), all equity contributed is considered at risk. The venture uses its capital to purchase a fixed income investment grade bond for $3,000; no other investments will be purchased by the venture. The venture also writes a call option to Investor 2 allowing Investor 2 to purchase the fixed income investment grade bond for $3,500 after three years.

Evaluation

In this example, all returns generated by the venture will be received by the at-risk equity group. However, because the returns received by the equity investors through their at-risk equity investments are capped by the call option held by Investor 2, the venture in this example is a VIE under ASC subparagraph 810-10-15-14(b)(3) because the call option is not an at-risk equity investment.

Question 4.2.70.1: Other Variable Interest Holders Receive Expected Residual Returns

Is there a requirement under ASC subparagraph 810-10-15-14(c)(3) that all of an entity’s expected residual returns must be received by the holders of an entity’s equity investment at risk?

Interpretive Response: No. Other variable interest holders may share in a portion of the expected residual returns of an entity with the at-risk equity investors if the sharing arrangement does not cap, explicitly or implicitly, the at-risk equity group’s returns. This concept is illustrated in the following example:

Background

Three investors form a partnership to acquire a commercial property for investment purposes. Each investor owns one-third of the outstanding equity interests, all of which are considered at risk under ASC subparagraph 810-10-15-14(a). The partnership acquires a commercial office property with the funds received upon formation. Because the investors are not familiar with the property management business, they hire an experienced property manager to identify tenants, negotiate and set leasing terms, and maintain the property. The property manager receives an annual fee of $100,000 and 25% of all partnership returns once it has achieved a 10% internal rate of return (IRR).
**Evaluation**

In this example, the condition in ASC subparagraph 810-10-15-14(b)(3) is not met because the returns of the at-risk equity investors are not capped (i.e., the holders of the equity investments at risk will receive 75% of all returns after a 10% IRR has been achieved).

**Question 4.2.70.2: Disproportionate Profit Sharing**

If the holders of an entity’s equity investment at risk share expected residual returns through their equity instruments in a manner that is disproportionate to their respective ownership percentages, would the entity be a VIE under ASC subparagraph 810-10-15-14(b)(3)?

**Interpretive Response:** No. Holders of equity at risk may agree to share an entity’s residual returns disproportionately to their respective ownership percentages (e.g., through allocation agreements, etc.) because ASC subparagraph 810-10-15-14(b)(3) is applied to the at-risk equity group as a whole. This concept is illustrated in the following example:

**Background**

Stone Co. (Stone) and Mineral Co. (Mineral) form a venture to mine and sell precious stones and minerals. At the time of formation, Stone contributes proven stone producing mines while Mineral contributes unproven, but potentially fertile mineral producing land. Because Stone has given up proven property, both partners have agreed to allocate the profits as follows:

- Stone will receive all profits until a cumulative 8% return has been reached;
- Mineral will then receive all profits until a cumulative 15% return has been reached;
- All profits in excess of a 15% cumulative return will be allocated to Stone.

**Evaluation**

While this profit allocation arrangement caps Mineral's returns, Stone's returns are not capped. Because all of the venture’s returns are allocated, as a group, to the holders of its at-risk equity, the condition in ASC subparagraph 810-10-15-14(b)(3) is not met.
Question 4.2.70.3: Interests in Specified Assets

Is an entity a VIE under ASC subparagraph 810-10-15-14(b)(3) if the returns are capped on any of its assets?

Interpretive Response: Not necessarily. Unless the returns are capped on substantially all of the entity’s assets through an interest that is a variable interest (i.e., because it relates to assets comprising more than 50% of the fair value of the entity’s total assets), we believe any cap on the returns of specified assets of the entity would not result in the condition in ASC subparagraph 810-10-15-14(b)(3) being met. This concept is illustrated in the following example:

**Background**

Assume a real estate partnership was formed to purchase and manage two industrial warehouses. The partnership is capitalized by debt of $80 million and equity of $20 million. All equity is considered at risk under ASC subparagraph 810-10-15-14(a). After it is formed, the partnership acquires two buildings (Warehouse 1 and Warehouse 2) for $55 million and $45 million, respectively. The tenant of Warehouse 1 has the option to purchase the property for $55 million at the end of its 10-year lease.

**Evaluation**

Although the fixed price purchase option held by the tenant of Warehouse 1 is a variable interest in the partnership and caps the returns that inure to the partnership’s at-risk equity investors with respect to Warehouse 1, it does not cap the equity investors’ right to receive the partnership’s expected residual returns because the returns from Warehouse 2 are not capped. Accordingly, the fixed price purchase option would not cause the condition in ASC subparagraph 810-10-15-14(b)(3) to be met.

Conversely, if the tenant of Warehouse 2 also held an option to purchase Warehouse 2 for $45 million upon the conclusion of its lease, then we believe the condition in ASC subparagraph 810-10-15-14(b)(3) would be met even though the purchase option on Warehouse 2 would not represent a variable interest in the entity as a whole because the returns on substantially all of the partnership’s assets are capped. In that situation, the entity would be a VIE under ASC subparagraph 810-10-15-14(b)(3).

4.2.80. Disproportionality between Voting Rights and Economics

4.2.80.10. In concluding whether the equity participants as a group have the power to direct the activities that most significantly impact the economic performance of an entity, ASC subparagraph 810-10-15-14(c) requires an enterprise to consider whether the voting rights of the individual equity investors’
equity interests are disproportionate to their economic interests in the entity. The equity investors as a group cannot be deemed to have the power to direct the activities that most significantly impact the economic performance of an entity if substantially all of the entity’s activities either involve or are conducted on behalf of an investor (including the investor and its related parties viewed as a group) with disproportionately few voting rights in relation to its economic interest in the entity. This provision in ASC subparagraph 810-10-15-14(c) is an abuse prevention mechanism designed to ensure that an enterprise that would otherwise be required to consolidate a VIE under the provisions of ASC Subtopic 810-10 cannot avoid that requirement by organizing the entity with nonsubstantive voting interests. In practice it also can capture a number of circumstances that may not necessarily represent efforts to circumvent the standard. In a speech at the 2003 AICPA National Conference on Current SEC Developments, a member of the SEC staff commented on the disproportionality criterion for determining whether an entity is a VIE. An excerpt from the speech follows:

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<th>Excerpt from Speech by Eric Schuppenhauer</th>
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| The staff has received a number of inquiries on how to apply the guidance contained in the last sentence of paragraph 5 of FIN 46, soon to be paragraph 5(c) of FIN 46, as soon-to-be-modified [ASC paragraph 810-10-15-14(c)]. That sentence states, in part: "the equity investors as a group also are considered to lack characteristic if both of the following conditions are present:"

   1. The voting rights of some investors are not proportional to their obligations to absorb the expected losses of the [legal] entity, their rights to receive the expected residual returns of the [legal] entity, or both.
   2. Substantially all of the [legal] entity’s activities (for example, providing financing or buying assets) either involve or are conducted on behalf of an investor that has disproportionately few voting rights."

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.

Question 4.2.80.1: Types of Variable Interests to Be Considered When Evaluating the Anti-Abuse Provision

When evaluating whether the voting rights of an entity’s equity investors are proportional to their obligations to absorb the expected losses of the entity and their rights to receive the expected residual returns of the entity (obligations and rights), should the comparison only consider the obligations and rights embedded in the investors’ equity investments at risk?

Interpretive Response: No. We understand that the FASB intended the guidance in ASC subparagraph 810-10-15-14(c) to be applied to all variable interests held in an entity when determining whether the investors’ voting rights are proportional to their exposure to the entity’s variability. This is illustrated in the following example:

**Background**

An investor owns a 5% equity interest in a partnership and also provided it with $5 million of subordinated debt financing. In total, the investor’s debt and equity positions in the partnership comprise approximately 75% of the partnership’s total capitalization. Furthermore, substantially all of the partnership’s activities are conducted on the investor’s behalf. The investor’s voting rights are proportionate to its 5% equity interest.

**Evaluation**

Because the investor has an economic position in the partnership that approximates 75% of its capital structure (debt and equity financing), but has only a 5% voting interest, the investor has disproportionately few voting rights in relation to its economic interest (including both debt and equity variable interests) and resulting exposure to the partnership’s variability. This fact together with the fact that substantially all of the partnership’s activities are conducted on its behalf causes the partnership to be a VIE under ASC subparagraph 810-10-15-14(c).

4.2.80.20. To further illustrate how the provisions of ASC subparagraph 810-10-15-14(c) may be applied, assume a food processor (Food) and an investor (Bank) establish a venture. The venture’s legal agreements stipulate that the venture may only purchase Food’s foods. Food’s and Bank’s economic interests are 75% and 25%, respectively. Additionally, Bank has 66% of the venture’s voting rights. In this example, the venture likely would be a VIE under ASC subparagraph 810-10-15-14(c) because substantially all of the venture’s activities (i.e., purchasing Food’s foods) are conducted on behalf of Food, which has
disproportionately few voting rights in relation to its economic interest in the entity.

4.2.80.30. ASC Subtopic 810-10 does not provide guidance about the meaning of the phrase “substantially all of the legal entity’s activities." As discussed in Question 4.2.80.2, evaluating this provision requires judgment about the nature of the entity’s activities and the nature of the investor’s activities and its share of the entity’s economic risks and rewards.

**Question 4.2.80.2: Meaning of Substantially All**

What factors should be evaluated when determining whether substantially all of the entity's activities either involve or are conducted on behalf of an investor that has disproportionately few voting rights?

**Interpretive Response:** We believe that an evaluation of whether substantially all of the entity’s activities involve or are conducted on behalf of an investor that has disproportionately few voting rights requires judgment and an evaluation of all relevant facts and circumstances. Although the amount of the entity’s variability attributable to the investor with disproportionately few voting rights is an important factor to consider, we do not believe that an evaluation of this condition should be primarily quantitative in nature. Rather, this evaluation should also focus on qualitative factors, which may include (a) the nature of the entity’s business and the investor’s business, (b) whether interests other than the investor's are widely dispersed, (c) the rights and obligations of each variable interest holder and the role that each variable interest holder has in the entity’s operations, and (d) the reasons that the investor’s voting rights are disproportionately less than its economic interest in the entity.

When economics are skewed heavily toward an investor with disproportionately few voting rights (including the economics associated with related parties and de facto agents of that entity), this is a strong indicator that substantially all the entity’s activities either involve or are conducted on behalf of the reporting entity.

Other factors enterprises should consider when determining whether substantially all of an entity’s activities either involve or are conducted on behalf of an investor with disproportionately few voting rights include, but are not limited to:

- The nature and extent of decisions that the investor with disproportionately few voting rights can make;
- Whether most of the entity’s assets were acquired from the investor with disproportionately few voting rights;
- The significance of the entity’s operations to the investor with disproportionately few voting rights compared with their significance to other variable interest holders;
• Whether the nature of the entity’s operations are similar to those of the investor with disproportionately few voting rights;
• The amount of the entity’s products or services purchased from or sold to the investor with disproportionately few voting rights;
• Whether the entity’s employees are the same as or related to those of the investor with disproportionately few voting rights;
• Whether the investor with disproportionately few voting rights outsourced any of its activities to the entity;
• Whether the investor with disproportionately few voting rights is required to fund any losses incurred by the entity;
• The amount (if any) of the entity’s assets that have been leased to or from the investor with disproportionately few voting rights;
• Whether the entity’s employees are compensated based on the performance of the investor with disproportionately few voting rights;
• Whether the investor with disproportionately few voting rights has the right to purchase any of the entity’s assets (e.g., fixed price purchase options that are in the money, etc.); and
• Whether the entity can put (sell) any assets to the investor with disproportionately few voting rights.

We do not believe that the presence of any one factor is determinative that an entity is a VIE; determining whether substantially all of an entity’s activities are conducted on behalf of an investor with disproportionately few voting rights requires judgment and an evaluation of all relevant facts and circumstances as demonstrated in the following example:

**Background**

A venture is formed to acquire and manage commercial office properties. The property manager, one of the equity investors (Investor A) identifies the properties to be purchased, negotiates the purchase price, identifies prospective tenants, sets the lease terms and rental rates, collects rent from tenants, and maintains the properties. Investor A owns a 1% equity interest in the venture, which meets the definition of equity at risk under ASC subparagraph 810-10-15-14(a). One investor unrelated to the property manager, Investor B, owns the remaining 99%. Investor B is not engaged in the real estate business, has no decision-making rights, and is holding its interest as a passive real estate investment.

**Evaluation**

Because Investor B has disproportionately few voting rights relative to its economic interest, the venture would be considered a VIE if substantially all of the venture’s activities are conducted on behalf of Investor B. However, we do not believe that the size of Investor B’s
investment, in and of itself, would result in a conclusion that substantially all of the venture’s activities are conducted on behalf of Investor B. While this is a strong indicator that may be difficult to overcome in many fact patterns, the nature of the venture’s activities should be compared to those of Investor B to assist in performing this evaluation. In this example, despite the heavily skewed economics on behalf of Investor B, because the venture is involved in acquiring and managing commercial real estate and Investor B has no operations in the real estate business or ability to influence the operations of the venture, we believe that substantially all of the venture’s activities do not involve and are not conducted on behalf of Investor B. As such, the condition in ASC subparagraph 810-10-15-14(c) would not be met.

**Question 4.2.80.3: Consideration of Related Parties When Evaluating ASC Subparagraph 810-10-15-14(c) – Part 1**

How should related parties be considered when evaluating whether an entity is a VIE under ASC subparagraph 810-10-15-14(c)?

**Interpretive Response:** When evaluating the criteria in ASC subparagraph 810-10-15-14(c)(1) (i.e., whether the voting interests of some investors are disproportional to their exposure to the entity’s expected losses, expected residual returns, or both), the term investors refers to an individual investor and therefore excludes related parties and de facto agents. However, when evaluating the guidance in ASC subparagraph 810-10-15-14(c)(2) (i.e., whether substantially all of the entity’s activities either involve or are conducted on behalf of the investor with disproportionately few voting rights), the term investor should include its related parties, as defined in ASC Topic 850, *Related Party Disclosures*, other than de facto agents resulting from transfer restrictions as discussed in ASC subparagraph 810-10-25-43(d). When applying the guidance in ASC subparagraph 810-10-15-14(c), the FASB intended for an investor (excluding related parties) with disproportionately few voting rights to consider activities conducted by the entity on behalf of an investor’s related parties when evaluating whether substantially all of the entity’s activities involve or are conducted on its behalf. This is illustrated in the following example:

**Background**

Long Road Distributors (Long Road), a trucking transportation service company, Big Tire Enterprises (Big Tire), a manufacturer and refurbisher of radial tires for tractor trailers (also a related party of Long Road), and FinanceCo, an investment entity, establish a partnership to refurbish and sell worn or damaged radial tires. Long Road, Big Tire, and FinanceCo have equal voting rights; however, the partnership agreement allocates 45%, 10%, and 45% of the partnership’s profits and losses, respectively, to each entity. All equity in the partnership is
deemed to be at risk and sufficient to absorb the partnership’s expected losses under ASC subparagraph 810-10-15-14(a). The partnership enters into a 25-year exclusive outsourcing arrangement to have Big Tire refurbish all worn or damaged tires that the partnership will sell. The partnership estimates that 95% of the refurbished tires will also be sold to Big Tire’s independent tire dealerships. Sales of refurbished tires represent the only source of the partnership’s revenues.

**Evaluation**

In this example, Long Road’s voting rights (one-third) are disproportionate to its obligation to absorb expected losses (45%) through its equity interest. If the voting rights held by Big Tire, which is a related party of Long Road, were aggregated with Long Road’s equity interest, then the related party group would not have disproportionately few voting rights in relation to its combined exposure to the variability of the partnership. However, as discussed above, related parties are ignored when evaluating whether the voting interests of some investors are disproportional to their economic interests in the entity.

While the partnership’s activities (i.e., refurbishing and reselling worn or damaged radial tires) are not substantially similar to Long Road’s primary activities of transporting goods, they are substantially similar to Big Tire’s operations (i.e., because Big Tire ordinarily engages in refurbishing and selling radial truck tires). Because the partnership’s sales of refurbished tires to Big Tire’s independent tire dealers comprise approximately 95% of the partnership’s revenues, substantially all of the partnership’s activities are deemed to be conducted on behalf of a related party of the investor (Long Road) with disproportionately few voting rights. As such, the partnership would be a VIE under ASC subparagraph 810-10-15-14(c).

**4.2.80.35** As discussed in Question 4.2.80.3, when economics are skewed heavily toward an investor with disproportionately few voting rights, this is a strong indicator that substantially all the entity’s activities either involve or are conducted on behalf of the reporting entity and its related parties, when taken as a group. When evaluating a legal entity in which all, or the majority, of the variable interests are held by related parties, a reporting entity should be aware of the requirement to consider the activities of its related parties in combination with its own, because the combination could result in the legal entity meeting the criterion in ASC subparagraph 810-10-15-14(c)(2). This is illustrated in the following example.
Question 4.2.80.3a: Consideration of Related Parties When Evaluating ASC Subparagraph 810-10-15-14(c) – Part 2

Background

A venture is formed to manufacture golf carts. Investor A and Investor B hold a 55% and 45% economic interest in the venture, respectively. Investor A and Investor B must agree on all significant decisions, including approving the operating and capital budgets, and hiring, firing, and setting the compensation of management. Investor A and Investor B are related parties.

Evaluation

Investor A has disproportionately few voting rights in proportion to its economic interest because its voting rights approximate 50% while its economic interest is 55%. When evaluating ASC subparagraph 810-10-15-14(c)(2), 100% of the venture’s economic interests would be ascribed to Investor A because it must consider activities that involve or are conducted on behalf of its related parties in the analysis. Because 100% of the economic interest are ascribed to Investor A’s related party group, absent other substantive factors, Investor A would conclude that substantially all of the venture’s activities involve or are conducted on behalf of Investor A and the venture would be a VIE.

Question 4.2.80.4: Consideration of De Facto Agents under ASC Subparagraph 810-10-15-14(c)

Should de facto agency relationships, as defined in ASC paragraph 810-10-25-43, be considered when evaluating the guidance in ASC subparagraph 810-10-15-14(c)?

Interpretive Response: When evaluating whether substantially all of the entity’s activities involve or are conducted on behalf of the party with disproportionately few voting rights, ASC subparagraph 810-10-15-14(c)(2) states that related parties should include de facto agents as defined in ASC paragraph 810-10-25-43, with the exception of de facto agents identified under ASC subparagraph 810-10-25-43(d).

Under ASC subparagraph 810-10-25-43(d), a party is a de facto agent of an enterprise if that party has an agreement that it cannot sell, transfer, or encumber its interest in the entity without the prior approval of the enterprise because such an arrangement may prevent the party from being able to manage the economic risks and rewards of its interest in the entity. A right of prior approval held by the party and enterprise that are based on mutually agreed-upon terms would not create a de facto agency relationship.

As stated in subparagraph 810-10-15-14(c)(2), the FASB intended the anti-abuse provision to prevent a primary beneficiary from avoiding consolidation by structuring an entity with nonsubstantive voting interests. If de facto agency
relationships identified under ASC subparagraph 810-10-25-43(d) were not excluded from the scope of the anti-abuse provision, certain entities that the FASB did not intend to be considered VIEs would be identified as VIEs. That is, considering the de facto agent’s interests in an entity together with the enterprise’s interests in an entity may result in an inappropriate conclusion that substantially all of the entity’s activities either involve or are conducted on behalf of the investor with disproportionately few voting rights. This is illustrated in the following example:

**Background**

Big Luxe Developers (Big Luxe) and ABC Investing (ABC) form a venture to develop a luxury ski resort in the Midwest. Big Luxe is responsible for identifying the development site, identifying subcontractors, sourcing raw materials, and directing all development-related activities. Once fully developed, Big Luxe will manage and maintain the ski resort’s operations. Big Luxe and ABC own 25% and 75%, respectively, of the venture interests; Big Luxe in the form of Class A shares and ABC in the form of Class B shares. ABC is not in the business of developing real estate and is holding its interest as a passive real estate investment. Big Luxe, through its Class A shares, has the power to make all decisions affecting the economics of the venture. ABC’s Class B shares do not carry substantive participating or kick-out rights.

Under the venture agreement, Big Luxe is prohibited from selling, transferring, or encumbering its interest in the venture without ABC’s prior consent; however, ABC does not have this restriction. At the time of inception, ABC requested this provision so that it would have adequate time to find a replacement developer and manager should Big Luxe wish to sell its investment and exit the project. Assume that under ASC subparagraph 810-10-25-43(d), Big Luxe is considered a de facto agent of ABC.

**Evaluation**

In this scenario, the criteria in ASC subparagraph 810-10-15-14(c)(1) have been met because ABC’s voting interests (no decision-making rights) are disproportionate to its economic interests in the entity (75% venture interest). If ABC was required under ASC subparagraph 810-10-15-14(c)(2) to consider Big Luxe a de facto agent because of the transferability restriction, it might conclude that substantially all of the entity’s activities (developing and managing real estate) involve or are conducted on its behalf. However, because de facto agency relationships identified under ASC subparagraph 810-10-25-43(d) are not considered when evaluating whether an entity is considered a VIE under ASC subparagraph 810-10-15-14(c), the criteria in ASC subparagraph 810-10-15-14(c)(2) would not be met and the venture would not be considered a VIE because of this provision.
Under ASC subparagraph 810-10-25-43(e), a party that has a close business relationship with the reporting enterprise like the relationship between a professional service provider and one of its significant clients is a de facto agent of the reporting enterprise. In a speech at the 2008 AICPA National Conference on Current SEC and PCAOB Developments, a member of the SEC staff commented on the disproportionality criterion for determining whether an entity is a VIE. An excerpt from the speech follows:

Excerpt from Speech by Robert B. Malhotra

Under [ASC paragraph 810-10-15-14(c)] an entity is subject to [the VIE provisions of ASC Subtopic 810-10] if 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 substantially all of the entity’s activities either involve or are conducted on behalf of an investor that has disproportionately few voting rights. Further, [ASC paragraph 810-10-15-14(c)] clarifies activities that involve or are conducted on behalf of the related parties of an investor with disproportionately few voting rights shall be treated as if they involve or are conducted on behalf of that investor.

In the context of [ASC paragraph 810-10-15-14(c)], the staff has been asked whether certain close business associates may be considered related parties under [ASC Topic 850] or [ASC paragraph 810-10-25-43]. In this context, the staff believes that close business associates may only be considered related parties if one party can control or can significantly influence the other party to an extent that one of the parties might be prevented from fully pursuing their own separate interest should that party choose to do so. That being the case, the mere past practice or future intent of close business associates to collaborate would be insufficient to conclude the parties are related. The staff believes that this is consistent with the definition of a related party included in [ASC Subsection 810-10-20].

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Question 4.2.80.5: Evaluating All Disproportionality between Voting Rights and Variable Interests

Would any disproportionality between an investor’s voting rights and its variable interests (i.e., obligation to absorb expected losses, rights to receive expected residual returns, or both) in an entity require an evaluation under ASC subparagraph 810-10-15-14(c)(2) as to whether substantially all of the entity’s activities involve or are conducted on behalf of that investor (including its related parties and de facto agents, except those identified under ASC subparagraph 810-10-25-43(d))?
Interpretive Response: Yes. Any disproportionality between an investor’s voting rights and its variable interests would require an evaluation of whether the criteria in ASC subparagraph 810-10-15-14(c)(2) are met. We believe that in most entities there is disproportionality between the equity-at-risk investors’ voting rights and their variable interests and, consequently, the criterion in ASC subparagraph 810-10-15-14(c)(1) typically will be met, particularly when all of the entity’s variable interests are not held by the equity-at-risk-investors on a pro-rata basis (e.g., some, but not all of the equity-at-risk investors hold debt of the entity) or the entity is a limited partnership or similar entity such as a limited liability company with governing provisions that are the functional equivalent of a limited partnership. Accordingly, in most entities, we believe that whether the entity is a VIE under ASC subparagraph 810-10-15-14(c) will depend on whether the criteria in ASC subparagraph 810-10-15-14(c)(2) are met. In many limited partnership arrangements, the general partner has 100% of the voting rights and possesses all decision-making rights while the limited partners have no voting rights. In these situations, the condition in ASC subparagraph 810-10-15-14(b)(1)(ii) would be met and the limited partnership would already be considered a VIE. Therefore there would be no need to perform an evaluation under ASC subparagraph 810-10-15-14(c). However, in other entities (including some limited partnerships), one equity-at-risk investor has the right to make the decisions about the activities that most significantly impact the entity’s economic performance only with the approval of another equity-at-risk investor (i.e., one of the equity-at-risk investors has substantive participating rights). In these situations, we believe that each equity-at-risk investor has 50% of the voting interests for purposes of evaluating the provisions of ASC subparagraph 810-10-15-14(c)(1). This is illustrated in the following examples:

**Example A:** Investor 1 and Investor 2 contribute $75 and $25, respectively, in exchange for an equity interest in a newly created real estate investment partnership. Both investors must agree to decisions about all significant activities, including the approval of the annual operating budget, before any actions are taken. Under the partnership agreement, profits and losses are allocated in direct proportion to each investor’s equity interests.

**Evaluation**

In this example, there is disproportionality between the investors’ voting rights and their economic interests (i.e., they receive 75% and 25%, respectively, of the partnership’s profits or losses, but each have 50% of the partnership’s voting rights). As a result, each investor must evaluate whether the criteria in ASC subparagraph 810-10-15-14(c)(2) are met.

**Example B:** In addition to the facts in Example A, assume that Investor 2 makes a subordinated loan to the partnership, which increases its exposure to expected losses of the partnership to 55%.
**Evaluation**

In this example, there is also disproportionality between the investors’ voting rights and their economic interests (i.e., they absorb 55% and 45%, respectively, of the partnership’s expected losses, but each have 50% of the partnership’s voting rights). As a result, each investor must evaluate whether the criteria in ASC subparagraph 810-10-15-14(c)(2) are met.

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**Example 4.2.80.1: Real Estate Investment Limited Partnership**

**Description of the Arrangement**

A single-purpose limited partnership (LP) acquires a stabilized, leased commercial real estate asset for $1 million. The general partner’s (GP) initial equity contribution is $15,000 (1.5% of overall capitalization and 5% of total equity capital). Two LPs contribute the remaining initial partnership equity in the amounts of $270,000 and $15,000, respectively (total LP interests are 28.5% of overall capitalization and 95% of total equity capital). In addition, there is senior debt financing totaling $700,000 that is nonrecourse to the partners or other assets of the partnership.

The cash waterfall from the overall performance of the real estate follows:

1. Payment to senior debt interest;
2. Payment of GP management fees/expenses (fixed, not variable with performance);
3. Payment of other expenses and capital improvements/repairs and maintenance;
4. Repayment of senior debt principal;
5. 9% annual preference return on investment to LPs;
6. 9% annual preference return on investment to GP;
7. Return of LPs capital;
8. Return of GP capital; and
9. Fifty-fifty sharing of all remaining returns between GP and LPs.

The arrangement is designed by the partners so that neither the GP nor the LPs will be required to consolidate the partnership under the requirements of ASC Subtopic 810-10. The GP controls the daily activity of the partnership within established parameters. The 90% LP has participating rights that equate generally to joint control on key decisions and therefore the condition in ASC subparagraph 810-10-15-14(b)(1)(ii) is not met. The 5% LP is the lessee of approximately 95% of the property’s space and has protective rights only. Certain key actions (e.g., sale of the property) cannot be undertaken if the GP and the 90% LP do not agree. The partnership agreement contains a
dissolution provision if the GP and the 90% LP cannot agree on significant actions. The dissolution provision requires that the party initiating the dissolution (either the GP or the 90% LP) offer to purchase the interest of the other party. (Although the GP has significantly less financial capability, it is a subject matter expert for the related real estate and market and has access to other potential LPs to refinance the partnership.) The other party must either agree to sell or purchase at that price. In the event of a dissolution, the 5% LP has a right of first refusal to purchase the interest being sold as a result of the dissolution for the price established upon the dissolution.

Evaluation

The partnership is a VIE under ASC subparagraph 810-10-15-14(c). Because the partners’ voting rights are disproportionate to their variable interests, the determination about whether the entity is a VIE depends on whether substantially all of the partnership’s activities either involve or are conducted on behalf of one of the LPs (whose voting rights are disproportionately few in relation to their economic interests).

In this example, the fact that the 5% LP leases approximately 95% of the property’s space indicates that substantially all of the partnership’s activities are being conducted on behalf of the 5% LP. Accordingly, the partnership is a VIE because (i) the voting rights of some investors are disproportional to their obligations to absorb the expected losses of the entity, to receive the expected residual returns of the entity, or both, and (ii) substantially all of the entity’s activities either involve or are conducted on behalf of an investor (the 5% LP) with disproportionately few voting rights.

The answer likely would change under any of the following circumstances:

1. The 5% LP holds $15,000 of the debt interests rather than an LP interest.
2. The 5% LP holds neither a debt nor an LP interest (i.e., its only interest is a lessee of the property).
3. The 5% LP is the lessee of only 50% of the property’s space.

In the first two circumstances, the answer would change because the lessee would not be considered an investor, because that term is used in the context of an equity investor in ASC subparagraph 810-10-15-14(c). In the third circumstance, the answer would change because the lessee’s level of usage is not sufficient to indicate that substantially all of the partnership’s activities are being conducted on its behalf.
Example 4.2.80.2: Real Estate Development Limited Partnership

Description of the Arrangement

A real estate development limited partnership is formed with the following owners:

- Company A – 40% LP interest
- Company B – 59% LP interest
- Company C – 1% GP interest

Company A is a real estate developer that sells to the partnership 100% of the real estate that the partnership will develop. There are no debt interests in the partnership. Company C (the GP) controls the daily activity of the partnership within established parameters. The LPs as a group have participating rights that equate generally to joint control with the GP on key decisions and therefore the condition in ASC subparagraph 810-10-15-14(b)(1)(ii) is not met. The partners participate in losses of the partnership in proportion to their partnership interests. Gains of the partnership are shared in proportion to the partners’ interests after payment of a preference return to Company C that is determined as a percentage of the appreciation in the value of the property.

Evaluation

The partnership is a VIE under ASC subparagraph 810-10-15-14(c). The voting interests of the partners are disproportionate to the economic interests of the partners. The GP’s voting interest resulting from its operational control and the need for its approval on certain key decisions is disproportionately greater than its 1% economic interest. Thus, the voting interests of the limited partners are disproportionately less than their collective 99% economic interest. Accordingly, the conclusion about whether the partnership is a VIE depends on whether substantially all of the partnership’s activities either involve or are conducted on behalf of an investor with disproportionately few voting rights.

Based on the facts in this example, substantially all of the partnership’s activities would be deemed to involve or be conducted on behalf of Company A because Company A is a real estate developer that provides all of the real estate under development by the partnership (i.e., Company A and the partnership appear to be in the same business with substantially similar activities). Accordingly, the partnership is a VIE because (i) the voting rights of some investors are not proportional to their obligations to absorb the expected losses of the entity, to receive the expected residual returns of the entity, or both, and (ii) substantially all of the entity’s activities either involve or are conducted on behalf of an investor that has disproportionately few voting rights.
Example 4.2.80.3: Illustration of the Provisions in ASC Subparagraph 810-10-15-14(c)

The following examples illustrate how the provisions in ASC subparagraph 810-10-15-14(c) may be applied:

Example A: RH Tractors (RH), a tractor manufacturer, establishes a partnership with Investor BW (BW) to purchase tractors and sell them to dealers in upstate New York. In exchange for 50% equity interests, RH contributes new tractors with a fair value of $1 million and BW contributes $1 million in cash upon formation of the partnership. All decisions relative to the operations of the partnership must be jointly agreed to by RH and BW. Profits and losses are shared equally (in direct proportion to ownership interests) until the investors achieve an internal rate of return of 10%, at which point RH receives 75% of the partnership’s profits.

Evaluation

In the fact pattern above, RH’s voting rights are disproportionately less than its exposure to the expected losses and expected residual returns of the entity. However, the partnership may not be considered a VIE under ASC subparagraph 810-10-15-14(c) if substantially all of the partnership’s activities are not conducted on RH’s behalf. Judgment and an evaluation of all facts and circumstances is required when determining whether substantially all of an entity’s activities are conducted on behalf of an equity-at-risk investor with disproportionately few voting rights. For example, if the partnership will not acquire substantially all of the tractors to be sold to dealers from RH, substantially all of its activities may not be conducted on behalf of RH.

Example B: Assume that the partnership in Example A is required to sell all tractors to RH-franchised dealerships.

Evaluation

RH’s voting rights are disproportionately less than its exposure to the expected losses and expected residual returns of the entity. Because all of the tractors are sold to RH-franchised dealerships, substantially all of the partnership’s activities would be deemed to either involve or be conducted on its behalf and, therefore, the condition in ASC subparagraph 810-10-15-14(c) would be met and the partnership would be considered a VIE.

4.3. DEVELOPMENT STAGE ENTITIES

4.3.10. Elimination of Development Stage Entities Guidance

4.3.10.10. Development stage entities are not exempt from the VIE consolidation or disclosure requirements of ASC Subtopic 810-10. Many development stage entities go through multiple phases of existence (e.g., research, clinical testing, regulatory approval, manufacturing, and marketing) before they are no longer
considered to be in the development stage. The definition of a development stage entity and related VIE guidance (i.e., with respect to how to evaluate whether a development stage entity has sufficient equity at risk) in ASC Subtopic 810-10 were eliminated with the issuance of FASB Accounting Standards Update No. 2014-10 (ASU 2014-10), Elimination of Certain Financial Reporting Requirements, Including an Amendment to Variable Interest Entities Guidance in Topic 810, Consolidation, which is effective for annual and interim periods in fiscal years beginning after December 15, 2015 for public business entities and annual periods in fiscal years beginning after December 15, 2016, and interim periods within annual periods beginning after December 15, 2017 for all other entities. As a result, after the adoption of ASU 2014-10, the VIE analysis is consistent for all entities, including those that would have been development stage entities under ASC Topic 915, Development Stage Entities, prior to the Topic being superseded.

4.3.20. Practical Considerations

4.3.20.10 Development stage entities are treated like any other entity when evaluating whether they are VIEs, regardless of whether they have commenced planned principal operations or have significant revenue from their principal operations. All entities within the scope of the VIE Subsections of Subtopic 810-10 are required to evaluate whether the total equity investment at risk is sufficient using the guidance in ASC paragraphs 810-10-25-45 through 25-47, which requires both qualitative and quantitative evaluations.

4.3.20.20 In our view, the ASU 2014-10 amendments are not likely to have a significant effect on whether development stage entities are VIEs. Before those amendments, ASC paragraph 810-10-15-16 indicated that the sufficiency of a development stage entity’s equity at risk should be determined based on the entity’s current activities. However, the determination of an entity’s expected losses (which the amount of the entity’s equity at risk must exceed to be considered sufficient under a quantitative evaluation) is based on the fair value of the entity’s existing assets and the net income or loss that will be generated from those assets (i.e., the activities it currently is engaged in), even if the entity is not a development stage entity. Consequently, there should be little, if any, difference in the conclusion about whether a development stage entity’s equity at risk is sufficient under the regular VIE guidance (i.e., excluding ASC paragraph 810-10-15-16). In addition, development stage entities were, and continue to be, subject to the requirements of ASC subparagraphs 810-10-15-14(b) and 15-14(c).

Question 4.3.20.1: Sufficiency of Equity At Risk for an Entity That Previously Met the Definition of a Development Stage Entity under ASC Topic 915

How should a reporting enterprise evaluate the sufficiency of the equity at risk under ASC subparagraph 810-10-15-14(a) for an entity that previously met the definition of a development stage entity under ASC Topic 915?
**Interpretive Response:** The evaluation should be based on the fair value of the entity’s existing assets and the net income or loss that will be generated from those assets. The fair value of the existing assets and activities of an entity that carries out its operations in phases may be affected by the likelihood or feasibility of completing the phase that the entity is currently engaged in. When it is highly uncertain whether the current phase of the entity’s activities will be successfully completed, this will likely limit the quantitative determination of the entity’s expected losses to that phase. However, when it is probable that the entity will progress beyond the phase that it is currently engaged in, the quantitative determination of the entity’s expected losses may be affected by expectations about phases beyond that phase.

ASC subparagraph 810-10-35-4(c) requires a reconsideration of whether an entity is a VIE (including whether its equity at risk is sufficient) when the entity undertakes additional activities or acquires additional assets that were not contemplated at the later of the entity’s inception or its latest reconsideration event and that increase the entity’s expected losses. Therefore, if the quantitative determination of an entity’s expected losses based on its existing assets and the net income or loss that will be generated from those assets excludes future phases of the entity’s planned operations, the sufficiency of its equity will need to be reconsidered if and when the entity reaches those future phases. See also Question 6.2.40.1 for the evaluation of power under ASC subparagraph 810-10-25-38A(a) when the entity operates in phases.

**Question 4.3.20.2: Qualification for the Business Scope Exception**

Can a development stage entity be considered a business, as defined in ASC Topic 805, and therefore qualify for the business scope exception under ASC subparagraph 810-10-15-17(d)?

**Interpretive Response:** Sometimes. Under ASC Topic 805, a business comprises a set of activities and assets and does not necessarily have to be self-sustaining. Rather, it only has to be capable of producing outputs. Therefore, depending on the facts and circumstances, a development stage entity may meet the definition of a business and qualify for the scope exception provided in ASC subparagraph 810-10-15-17(d).

As discussed in paragraph 2.3.50.25., the FASB recently issued ASU 2017-01, *Clarifying the Definition of a Business* (ASU 2017-01). Under the ASU, an integrated set of activities and assets (a set) is a business if it has, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs. Under the new model, fewer sets are expected to meet the definition of a business and thus fewer will be eligible for the scope exception. The ASU is effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2017. It is effective for other entities for annual periods in fiscal years beginning after

4.4. RECONSIDERATION OF WHETHER AN ENTITY IS A VIE

4.4.10. Overview

Excerpt from ASC Subtopic 810-10

Initial Involvement with a Legal Entity

25-37 The initial determination of whether a legal entity is a VIE shall be made on the date at which a reporting entity becomes involved with the legal entity. For purposes of the Variable Interest Entities Subsections, involvement with a legal entity refers to ownership, contractual, or other pecuniary interests that may be determined to be variable interests. That determination shall be based on the circumstances on that date including future changes that are required in existing governing documents and existing contractual arrangements.

4.4.10.10. When an enterprise initially becomes involved with another entity, it must assess whether it has obtained a variable interest in the entity and, if so, whether the entity is in the scope of the VIE Subsections of ASC Subtopic 810-10 by evaluating the conditions in ASC paragraph 810-10-15-14 with respect to that entity. Involvement is not limited to interests in the form of equity or debt investments; it includes any kind of economic interest in the entity. Unless there is an applicable scope exception, we believe that it usually will be necessary for enterprises to evaluate whether entities in which they have a variable interest are VIEs. Although future changes that are required in an entity’s existing governing documents and contractual arrangements should be considered in evaluating whether the entity is a VIE, we believe the entity’s right to make capital calls on its equity investors is not equity of the entity until those amounts are received because they are not included in the entity’s U.S. GAAP equity until that time.

Example 4.4.10.1: Considering Future Changes to an Entity’s Capital Structure

Tasty Burger, a fast food restaurant franchisor, provides a subordinated loan to CompuBurger, the developer of a proprietary point of sale system that will speed the customer ordering process. At the time the loan is extended, CompuBurger is a VIE under ASC subparagraph 810-10-15-14(a) because its equity investment at risk is not sufficient to absorb its expected losses. Within three months of the loan’s origination, CompuBurger is expected to receive a new round of equity financing from a venture capital firm. The additional equity is expected to be sufficient to absorb CompuBurger’s expected losses.
Evaluation
While CompuBurger anticipates when it obtains the loan, that it will receive the future round of equity financing, it may only consider the circumstances that existed at the time the loan was entered into. Accordingly, CompuBurger is a VIE under ASC subparagraph 810-10-15-14(a). However, when the additional equity financing is obtained, CompuBurger would reconsider its VIE status at which time it would conclude that it is no longer a VIE if the conditions in ASC subparagraphs 810-10-15-14(b) and 15-14(c) also are not met. See the section below for additional guidance about reconsideration events.

Question 4.4.10.1: Existence of a Significance Threshold
Is there a significance threshold when determining whether to apply the guidance in the VIE Subsections of ASC Subtopic 810-10?
Interpretive Response: No. However, like other topics, the FASB does not require its guidance to be applied to immaterial items. Accordingly, unless there is an applicable scope exception, we believe that it usually will be necessary for enterprises to evaluate whether they have a variable interest in entities with which they have involvement and, if so, whether the entities are VIEs.

Excerpt from ASC Subtopic 810-10
Reconsideration of Initial Determination of VIE Status
35-4 A legal entity that previously was not subject to the Variable Interest Entities Subsections shall not become subject to them simply because of losses in excess of its expected losses that reduce the equity investment. The initial determination of whether a legal entity is a VIE shall be reconsidered if any of the following occur:

(a) The legal entity’s governing documents or contractual arrangements are changed in a manner that changes the characteristics or adequacy of the legal entity’s equity investment at risk.

(b) The equity investment or some part thereof is returned to the equity investors, and other interests become exposed to expected losses of the legal entity.

(c) The legal entity undertakes additional activities or acquires additional assets, beyond those that were anticipated at the later of the inception of the entity or the latest reconsideration event, that increase the entity’s expected losses.
(d) The legal entity receives an additional equity investment that is at risk, or the legal entity curtails or modifies its activities in a way that decreases its expected losses.

(e) Changes in facts and circumstances occur such that the holders of the equity investment at risk, as a group, lose the power from voting rights or similar rights of those investments to direct the activities of the entity that most significantly impact the entity's economic performance.

4.4.10.20. An enterprise with a variable interest in another entity should reconsider whether that entity is a VIE upon the occurrence of certain triggering events, as described in ASC paragraph 810-10-35-4. Those triggering events are intended to capture circumstances that indicate there may have been a change in the design of the entity. We believe this is the reason that both ASC paragraphs 810-10-15-14 and 35-4 indicate that an entity is not included in the scope of the VIE Subsections of ASC Subtopic 810-10 simply because losses in excess of its expected losses reduce the equity investment, even if the equity investment is reduced to zero. Taken by itself, incurring actual losses in excess of expected losses would not indicate that the voting interests are not an effective means of identifying the parties that have control over the entity if the entity was previously a voting interest entity (i.e., that circumstance alone would not indicate that the entity’s equity is insufficient by design). However, as an entity incurs losses in excess of its expected losses, the likelihood increases that the design of the entity will change. If one or more of the reconsideration events in ASC paragraph 810-10-35-4 occurs, we believe that the total fair value of the entity’s equity should be compared with the entity’s expected losses at that time to determine whether the entity is able to finance its activities without additional subordinated financial support.

4.4.10.30. The FASB provided the reconsideration events in ASC paragraph 810-10-35-4 so that an enterprise would not be required to reassess the VIE status of the entities it is involved with during each reporting period, but rather only upon the occurrence of certain events that may indicate that the entity’s design has changed. A triggering event would be significant if it involves a change in the design of the entity that indicates (1) the entity’s equity investment at risk may not be sufficient or (2) the at-risk-equity investors’ interests may no longer have the characteristics of a controlling financial interest.

4.4.10.40. The FASB decided in ASU 2009-17 that a troubled-debt restructuring is an event that should require a reconsideration of whether an entity is a VIE and whether an enterprise is the primary beneficiary of the entity. As discussed in paragraph A17 in the uncodified Basis for Conclusions of ASU 2009-17, the FASB decided that in a troubled-debt restructuring, the debtor would typically be identified as a VIE because economic events have demonstrated that the debtor’s equity is not sufficient to permit it to finance its activities without additional subordinated financial support or a restructuring of the terms of its financing. The FASB also observed that it may not be uncommon for the primary
beneficiary of a debtor involved in a troubled-debt restructuring to change as a result of the restructuring.

4.4.10.50. The FASB also decided to require a reconsideration of whether an entity is a VIE if the equity-at-risk investors lose the power through the rights of their equity interests to direct the activities that most significantly impact the entity’s economic performance. If an entity that previously was a voting interest entity experiences negative operating results and another party (e.g., a guarantor or lender) obtains this power under an existing agreement, the guidance in ASC paragraph 810-10-35-4 requires a reassessment of whether the entity is a VIE. Upon this reassessment, the entity would be considered a VIE under ASC subparagraph 810-10-15-14(b)(1).

4.4.10.60. When a reconsideration event as described in ASC paragraph 810-10-35-4 occurs, the nature of the risks that the entity was designed to create and disperse among its variable interest holders also should be reconsidered. All relevant facts and circumstances should be evaluated when determining whether the entity’s design has changed. See Section 3 for additional guidance about identifying the nature of the risks the entity was designed to create and disperse among its variable interest holders.

4.4.10.70. Identifying and monitoring for events in ASC paragraph 810-10-35-4 that require an enterprise to reevaluate whether an entity is a VIE may present ongoing operational challenges for an enterprise. For example, an entity that is continually changing in size and scope could shift in and out of VIE status as various reconsideration events occur. Due to these challenges, it is important for enterprises to establish robust internal controls to ensure that reconsideration events are identified on a timely basis. This likely will require establishing a process for obtaining information periodically from entities in which the enterprise holds variable interests (even if the enterprise is not the entity’s primary beneficiary or the entity is not currently a VIE).

Question 4.4.10.2: Equity Investors Obtain Power to Direct Activities

Does ASC subparagraph 810-10-35-4(e) permit or require a reconsideration of whether an entity is a VIE if the equity-at-risk investors, as a group, obtain the power through the rights of their equity interests to direct the activities that most significantly impact the entity’s economic performance?

Interpretive Response: No. The ASC paragraph 810-10-35-4(e) test is a one-way test that triggers reconsideration of whether an entity is a VIE only when the entity would become a VIE, not when a VIE would become a voting interest entity. When the equity-at-risk investors, as a group, obtain the power through the rights of their equity interests to direct the activities that most significantly impact the entity’s economic performance, other provisions of ASC paragraph 810-10-35-4 may be met that trigger a reconsideration of whether the entity is a VIE. For example, the entity may receive an additional equity investment that
is at risk or may curtail or modify its activities in a way that decreases its expected losses.

**Question 4.4.10.3: Change in Design Is Not a Prerequisite for a Reconsideration Event**

Is a change in an entity’s design a prerequisite for the reconsideration of an entity’s VIE status?

**Interpretive Response:** No. A change in an entity’s design does not need to occur for a reconsideration event to arise. Rather, the occurrence of a reconsideration event requires an evaluation of whether there has been a change in an entity’s design (i.e., the risks it was designed to create and distribute to its interest holders). Reconsideration events that may change the design of an entity include, but are not limited to:

- Transactions affecting an entity’s capital structure (e.g., debt financings, refinancings (including troubled debt restructurings) or early retirements; issuances of equity interests, capital contributions, and distributions);
- Changes to an entity’s business (e.g., new asset acquisitions, new leases, entry into new business lines that increase the entity’s expected losses and expected residual returns; disposal of a business); and
- Revisions to an entity’s legal agreements (e.g., changes to service or outsourcing contracts, changes to an equity investor’s voting rights, changes to or expiration of kick-out rights, liquidation rights, participating rights, or other rights affecting which party has the power to direct the activities that most significantly impact the entity’s economic performance).

The reconsideration events listed above would involve a change in the design of the entity if (1) the entity’s equity investment at risk either becomes adequate (i.e., the condition in ASC subparagraph 810-10-15-14(a) no longer is met) or inadequate (i.e., the condition in ASC subparagraph 810-10-15-14(a) is met) in relation to the entity’s expected losses upon the occurrence of the event or (2) the at-risk equity investors either obtain or lose the characteristics of a controlling financial interest (i.e., the conditions in ASC subparagraphs 810-10-15-14(b) and 15-14(c) either no longer are met or one or both of those conditions is met) upon the occurrence of the event. Nonsubstantive changes or events would not constitute a reconsideration event. Professional judgment based on consideration of all relevant facts and circumstances is important when evaluating whether an event is significant enough to warrant a reconsideration of an entity’s VIE status under ASC paragraph 810-10-35-4.
Question 4.4.10.4: Evaluating the Sufficiency of an Entity’s Equity upon Reconsideration

Upon the occurrence of a reconsideration event, should the sufficiency of the entity’s equity investment at risk be based on its fair value or carrying amount?

Interpretive Response: The fair value, rather than the carrying amount, of the entity’s equity investment at risk should be used in evaluating whether it is sufficient under ASC subparagraph 810-10-15-14(a). This is consistent with the measurement that would be used to evaluate the sufficiency of an entity’s equity at risk when an enterprise first obtains a variable interest in the entity.

Question 4.4.10.5: Accounts Receivable Are Converted into Notes Receivable

Depending on its receivable management process, an entity may convert noninterest-bearing accounts receivable into interest-bearing notes receivable. Would this conversion constitute a reconsideration event under ASC paragraph 810-10-35-4?

Interpretive Response: Not necessarily. A conversion would constitute a reconsideration event if it results in a change to the characteristics or adequacy of the entity’s at-risk equity. In addition, conversions of accounts receivable balances into notes receivable may be analogous to troubled debt restructurings, which are reconsideration events under ASC subparagraph 810-10-35-4(e). However, if the conversion is not analogous to a troubled debt restructuring and does not change the characteristics or adequacy of the entity’s at-risk equity, it would not constitute a reconsideration event.

Question 4.4.10.6: Implementing New Accounting Pronouncements

Does an entity’s adoption of a new accounting standard constitute a reconsideration event under ASC paragraph 810-10-35-4?

Interpretive Response: Unless the accounting standard requires the reconsideration of an entity’s VIE status upon adoption, we do not believe that a new accounting standard would constitute a reconsideration event.

Question 4.4.10.7: Returns of Equity

Must an entity’s VIE status be reconsidered pursuant to ASC paragraph 810-10-35-4 upon each distribution (i.e., return of capital) to its equity investors?

Interpretive Response: Not in all circumstances. If the entity’s expected losses exceed the fair value of its equity after the distribution, the distribution
would constitute a reconsideration event because interests other than equity at risk are exposed to the entity’s expected losses. In other situations, a distribution would not constitute a reconsideration event (i.e., where the fair value of an entity’s equity exceeds the entity’s expected losses following the distribution). This is illustrated in the following examples:

**Example A:** A real estate investment partnership is formed to purchase and manage a retail shopping center. Several storefronts in the shopping center are leased at market terms to various unrelated entities. At the end of its third year, the partnership begins to pay annual dividends to its equity investors equal to 70% of its annual net income. Before paying the dividends the partnership was not a VIE.

**Evaluation**

Because these distributions represent returns on equity (rather than returns of equity), we believe they typically would not give rise to a reconsideration event under ASC paragraph 810-10-35-4. However, if the fair value of the entity’s equity at risk before the distributions was only marginally in excess of its expected losses and the fair value of its assets had declined substantially without requiring recognition of an impairment loss, the distributions may give rise to a reconsideration event because the fair value of the equity may have declined to a level that is less than the entity’s expected losses, thereby exposing interests other than the equity at risk to expected losses of the entity.

**Example B:** Assume that the real estate investment partnership in Example A restructures its debt and, due to appreciation in the value of the retail shopping center, distributes amounts to its equity investors in excess of the partnership’s net income.

**Evaluation**

If the return of capital exposes other variable interest holders (i.e., the lenders) to expected losses of the entity (i.e., if the fair value of equity after the distributions is less than the expected losses of the entity), the loan restructuring and return of capital would constitute reconsideration events under ASC paragraph 810-10-35-4. However, if the fair value of the entity’s equity at risk after the loan restructuring and distribution was in excess of the entity’s expected losses, the restructuring and distribution would not constitute reconsideration events because the entity’s equity at risk would remain sufficient to absorb its expected losses.

**Example C:** Assume that the real estate investment partnership in Example B was a VIE before the restructuring of its debt and resulting distribution to its equity investors.
Evaluation

The loan restructuring and return of capital would not constitute reconsideration events under ASC paragraph 810-10-35-4 because the entity is already a VIE and, therefore, the loan restructuring and distribution do not change the characteristics or adequacy of its equity at risk (i.e., its equity at risk was either inadequate or lacked the characteristics necessary to be evaluated for consolidation on the basis of voting control before the restructuring and distribution occurred).

Question 4.4.10.8: Transfer of Debt

Would a reconsideration event occur if an entity’s debt is transferred from the original lender to a different lender?

Interpretive Response: No. This transfer would not result in a change to the characteristics or adequacy of the entity’s equity at risk and, therefore, would not give rise to a reconsideration event under ASC subparagraph 810-10-35-4(a). Based on informal discussions with the FASB staff, we understand that the debt acquirer should evaluate the entity’s original design or its design at the most recent reconsideration event, if any, to determine whether it is a VIE. (If it is not practicable for the debt acquirer to evaluate the entity’s original design or its design at the most recent reconsideration event as applicable, we believe the debt acquirer should evaluate the entity’s design based on the facts and circumstances upon the acquisition of the debt.) If the entity is not deemed to be a VIE, the debt holder would follow other applicable U.S. GAAP to account for its interest.

Question 4.4.10.9: Losses That Reduce the Entity’s Equity Investment At Risk

Do all losses that reduce an entity’s equity investment at risk require a reconsideration about whether the entity has sufficient equity?

Interpretive Response: No. We believe that losses that reduce an entity’s equity investment at risk do not give rise to a reconsideration event, even when the fair value of the entity’s equity is reduced to zero. That is, if the entity’s equity at risk at inception was deemed sufficient under ASC subparagraph 810-10-15-14(a), then the fact that losses have occurred would not, by itself, trigger the need to reconsider whether the entity is a VIE. However, if an entity’s losses have resulted in the occurrence of events that are specifically listed as reconsideration events in ASC paragraph 810-10-35-4, (e.g., another party such as a lender or guarantor has obtained control of the entity), then a reconsideration of whether the entity is a VIE is required.
**Question 4.4.10.10: Bankruptcy as a Reconsideration Event**

Does a reconsideration event occur if an entity files for bankruptcy or emerges from bankruptcy?

**Interpretive Response:** Upon the occurrence of a bankruptcy filing, an entity’s equity investors typically lose the power to direct the activities that most significantly impact the entity’s economic performance. Therefore, we believe that a bankruptcy filing would require an enterprise to reassess an entity’s VIE status under ASC subparagraph 810-10-35-4(e). Often, entities that file for bankruptcy would likely be considered VIEs because the equity investment at risk is not sufficient and/or the equity investors may no longer have power to direct the activities that most significantly impact the entity’s economic performance (i.e., the bankruptcy court may control the entity). It is likely that the enterprise (if any) that consolidated an entity before its bankruptcy filing will be required to deconsolidate it after the bankruptcy filing because the equity investors lack the power to direct the activities that most significantly impact the entity’s economic performance.

We believe that in most cases, an entity's emergence from bankruptcy also would trigger reconsideration of the entity's VIE status. When emerging from bankruptcy, an entity's governing documents often establish new equity and other contractual arrangements that change the characteristics of the entity's equity investment at risk. In situations where the characteristics of the entity's equity investment at risk change, the criterion in ASC subparagraph 810-10-35-4(a) is met and the entity's VIE status should be reconsidered.

**Question 4.4.10.11: Changes in Governing Documents or Contractual Arrangements**

Do all changes made to an entity’s governing documents or contractual arrangements give rise to a requirement to reconsider whether the entity is a VIE?

**Interpretive Response:** No. If the change is not substantive or does not result in a change in the characteristics or adequacy of the entity’s equity at risk, no reconsideration of whether the entity is a VIE should be performed. Changes in the entity’s governing documents or contractual arrangements that are substantive and change the characteristics or adequacy of its at-risk equity require a reconsideration of whether the entity is a VIE.

A reconsideration of whether an entity that is a VIE could result in a conclusion that it is no longer a VIE and a reconsideration of whether an entity that is not a VIE could result in a conclusion that it is a VIE.

The FASB emphasized in ASU 2009-17 that when applying the VIE guidance in ASC Subtopic 810-10 "only substantive terms, transactions, and arrangements, whether contractual or noncontractual, shall be considered."
ASC paragraph 810-10-15-13A indicates that transactions should be disregarded if they do not have a substantive effect on an entity’s VIE status, an enterprise’s power over a VIE, or an enterprise’s obligation to absorb losses or its right to receive benefits of the entity. Professional judgment will be required to determine whether terms, transactions, and arrangements are substantive. In general, it is expected that substantive terms, transactions, and arrangements have been designed to achieve specific business objectives other than a particular accounting outcome and affect the economic considerations of the parties involved. This is illustrated in the following examples:

**Example A:** A real estate investment partnership is formed to purchase and manage a grain storage warehouse. Upon formation, three equity investors contribute $1 million in exchange for partnership interests. The partnership also receives a $3 million senior loan from a bank. An unrelated party agrees to lease the entire warehouse at market terms for seven years. The partnership is considered a voting interest entity upon formation.

During its second year of existence, the partnership refinances its senior debt because of an increase in the fair value of its grain storage warehouse. The increase in the debt balance does not exceed the increase in the fair value of the grain storage warehouse. Proceeds received as a result of the refinancing are distributed to the equity investors.

**Evaluation**

Because the refinancing does not change the adequacy of the partnership’s equity investment at risk, we believe it would not trigger a reassessment of whether the partnership is a VIE.

**Example B:** Assume the same facts as in Example A. After three years, the terms of the lease are modified to extend its term from 7 years to 10 years. All other significant terms of the lease remain unchanged.

**Evaluation**

We do not believe the lease extension would give rise to a reconsideration event unless the partnership’s expected losses changed as a result of the modification.

**Example C:** Assume the same facts as in Example A. During the partnership’s seventh year, it purchases another grain warehouse for $5 million and leases it to a different unrelated party. As a result of the acquisition, the partnership’s expected losses increase.

**Evaluation**

Because the acquisition increases the partnership’s expected losses, a reconsideration event has occurred under ASC subparagraph 810-10-
35-4(c) and a reassessment of whether the partnership is a VIE must be performed.

**Example D:** Assume the same facts as in Example A. After four years in existence, the partnership agreement is modified so that partners may cast their votes by mail rather than be required to vote in person at the annual meeting.

**Evaluation**

While this represents a change to the partnership’s governing documents, it is not a substantive change and it does not affect the characteristics or adequacy of the partnership’s equity at risk. As such, it would not require a reconsideration of whether the partnership is a VIE.

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**Question 4.4.10.12: Temporary Financing Replaced by Long-Term Financing**

Does the replacement of temporary financing (e.g., during an entity’s development phase) with long-term financing (e.g., upon completion of development) constitute a reconsideration event under ASC paragraph 810-10-35-4?

**Interpretive Response:** Yes. We generally believe that replacing temporary financing with long-term financing would require a reconsideration of whether an entity is a VIE because it may change the characteristics or adequacy of the entity’s equity investment at risk. However, if the same lender provides both the temporary and long-term financing and all significant terms (e.g., balance, term, interest rate, covenants, etc.) of both arrangements are substantially agreed to upon at the date development begins, then we believe the conversion (i.e., rollover) from the temporary to long-term financing arrangement would not give rise to a reconsideration event. Rather, the terms of both arrangements should be considered when performing the initial determination of whether the entity is a VIE. This is illustrated in the following example:

**Background**

A real estate investment partnership is formed to develop a residential housing complex in New Jersey. Two partners contribute $100,000 in exchange for equity interests. The partnership also receives a temporary construction loan of $900,000 from a lender to help finance the project. Upon completion, the housing complex has a fair value of approximately $1,500,000. Because the fair value is higher than anticipated, the partnership obtains long-term financing at 75% of the housing complex’s fair value ($1,125,000) and uses the proceeds to repay the temporary construction loan ($900,000) and to return capital to the equity investors ($225,000).
**Evaluation**

In this situation, replacing temporary financing with long-term financing would not necessarily require a reconsideration of whether the partnership is a VIE. If the excess of the actual amount of long-term financing obtained over the amount that was contemplated at the entity’s formation does not exceed the excess of the fair value of the completed development over its anticipated fair value at the entity’s formation, then we believe the replacement of the temporary financing with long-term financing would not constitute a reconsideration event with respect to whether the partnership is a VIE. Otherwise, we believe the return of capital to the equity investors in excess of what was contemplated at the formation of the entity would represent a substantive change that would require a reconsideration of whether the partnership is a VIE.

**Question 4.4.10.13: Loss of Power Over an Entity**

Does a specific event need to occur for the holders of the equity investment at risk, as a group, to lose the power to direct the activities that most significantly impact the entity’s economic performance?

**Interpretive Response:** Generally, yes. Typically, the holders of the equity investment at risk, as a group, would not lose the power to direct the activities that most significantly impact an entity’s economic performance unless a specific event occurs. However, this event would not necessarily need to involve the revision of existing agreements or the execution of new agreements. Rather, the loss of power could also occur through mechanisms built into existing arrangements between two parties. For example, the terms of a loan may provide the lender with the power to direct the activities that most significantly impact the entity’s economic performance upon an event of default such as a decline in the fair value of the collateral below the outstanding principal balance of the loan. A lender also may obtain the right to foreclose on the collateral if there is a default on the borrower’s loan. If the collateral is of such significance to the borrower that decisions about the operations of the collateral represent the decisions that most significantly impact the borrower’s economic performance, the borrower does not have a substantive ability to cure the default, and there are no other substantive barriers to the lender’s exercise of its right to foreclose on the collateral, we believe that a lender’s foreclosure right should be evaluated in the same manner as a substantive unilateral kick-out right that would result in a loss of power on the part of the holders of the borrower’s equity at risk.

**Question 4.4.10.14: Asset Purchases and Sales**
Do all asset purchases and sales require an enterprise to reconsider whether an entity is a VIE?

**Interpretive Response:** We generally believe that asset purchases or sales constitute reconsideration events only if they significantly change an entity’s expected losses. For example, an entity may have acquired computers for all its employees that, when aggregated, may be material to the fair value of the entity’s assets or its operating results. However, if this purchase does not generate significant additional expected losses, it would not trigger a reconsideration event.

**Question 4.4.10.15: Acquired Business Has a Variable Interest**

If an enterprise acquires a business that holds a variable interest in an entity, would the entity’s VIE status need to be reconsidered?

**Interpretive Response:** Unless the entity’s design has changed or one of the reconsideration events in ASC paragraph 810-10-35-4 has been met, we do not believe that the entity’s VIE status would need to be reassessed. A business acquisition typically would only transfer a variable interest between the two parties involved in the transaction and not change the design of the variable interest in the entity or affect the characteristics or adequacy of the entity’s equity investment at risk. However, if the acquiring enterprise already has a variable interest in the entity, then the acquisition would require a reconsideration of whether the entity qualifies for the business scope exception in ASC subparagraph 810-10-15-17(d), if it was previously used, because acquiring additional interests in the entity may result in the consolidated enterprise providing more than half of the total of the equity, subordinated debt, and other forms of subordinated financial support to the legal entity based on an analysis of the fair values of the interests (ASC subparagraph 810-10-15-17(d)(3)).

**Question 4.4.10.16: Reconsideration Events and the Business Scope Exception**

Does a reporting enterprise need to re-evaluate its use of the business scope exception when a reconsideration event in ASC paragraph 810-10-35-4 occurs?

**Interpretive Response:** No. As discussed in Question 2.3.50.7, a reporting enterprise needs to continuously evaluate its eligibility for the business scope exception as the factors affecting the conditions in ASC subparagraphs 810-10-15-17(d)(1)-(4) change. However, the reconsideration events in ASC paragraph 810-10-35-4 may not necessarily affect the conditions in ASC subparagraphs 810-10-15-17(d)(1)-(4). If at the reevaluation date, none of the conditions in ASC subparagraphs 810-10-15-17(d)(1)-(4) exist, we believe the
reporting enterprise can continue to apply the scope exception and is not required to reevaluate whether the legal entity is a business (because being a business is not a condition of ASC subparagraph 810-10-15-17(d)).
5. Silos

Example 5.1: Silos

Question 5.1: Assets Financed Entirely with Nonrecourse Debt

Question 5.2: Silos That Involve More Than Half of a VIE’s Total Assets

Question 5.3: Fixed-Price Purchase Option in an Operating Lease

Question 5.4: Effect of a Silo on Whether an Entity Is a VIE

Question 5.5: Primary Beneficiary of a Silo

Question 5.6: Effect of a Silo on Consolidation of a Host VIE

Question 5.7: Effect of a Silo on Consolidation of a Host (Residual) Entity That Is Not a VIE
5.1.10.10. Sometimes the contractual arrangements within a VIE economically isolate a portion of the VIE’s assets, related liabilities, and certain other interests (e.g., guarantees and purchase options) from the rest of the VIE’s assets and related variable interests. In practice, these groups of assets, liabilities, and other interests often are referred to as silos.

5.1.10.20. Silos are explained in ASC paragraphs 810-10-25-57 and 25-58.

Excerpt from ASC Subtopic 810-10

25-57 A reporting entity with a variable interest in specified assets of a VIE shall treat a portion of the VIE as a separate VIE if the specified assets (and related credit enhancements, if any) are essentially the only source of payment for specified liabilities or specified other interests. (The portions of a VIE referred to in this paragraph are sometimes called silos.) That requirement does not apply unless the legal entity has been determined to be a VIE. If one reporting entity is required to consolidate a discrete portion of a VIE, other variable interest holders shall not consider that portion to be part of the larger VIE.

25-58 A specified asset (or group of assets) of a VIE and a related liability secured only by the specified asset or group shall not be treated as a separate VIE (as discussed in the preceding paragraph) if other parties have rights or obligations related to the specified asset or to residual cash flows from the specified asset. A separate VIE is deemed to exist for accounting purposes only if essentially all of the assets, liabilities, and equity of the deemed VIE are separate from the overall VIE and specifically identifiable. In other words, essentially none of the returns of the assets of the deemed VIE can be used by the remaining VIE, and essentially none of the liabilities of the deemed VIE are payable from the assets of the remaining VIE.

5.1.10.30. The FASB’s Emerging Issues Task Force (EITF) created the notion of silos to address a situation described in ASC paragraph 958-810-55-8 in which a special-purpose entity (SPE) leases two properties to two unrelated lessees. The SPE’s only assets are the leased properties and the related leases. Both properties are financed with separate nonrecourse borrowings that do not contain cross-collateral provisions, so that, in the event of default, each borrowing is collateralized only by a pledge of the respective assets leased to a single lessee and an assignment of the respective lease payments under the related lease.

5.1.10.40. ASC paragraph 958-810-25-8 requires a lessee to consolidate an SPE lessor that is not subject to the VIE consolidation requirements of ASC Topic 810, Consolidation, when three conditions are present in the transaction. One of those conditions is that substantially all of the activities of the SPE involve assets that were to be leased to a single lessee. After the requirements of ASC paragraph 958-810-25-8 became effective, lessees and lessors began to structure transactions so that a single SPE lessor contained assets leased to more than one lessee, thus allowing the individual lessees to avoid meeting the first condition of the paragraph and thereby reducing the potential for...
consolidation of the SPE lessor under its requirements. The EITF concluded that when these transactions involved nonrecourse debt, the economics of the transactions were similar regardless of whether they involved multiple SPEs or a single SPE with separate nonrecourse debt financing for each leased property. Therefore, the EITF concluded that the use of nonrecourse debt with no cross-collateral provisions effectively segregates the cash flows and assets associated with the multiple leases and, in substance, creates multiple SPEs or silos.

5.1.10.50. The FASB has a longstanding history of rejecting so-called pro-rata ownership of part of an entity’s assets and liabilities as a basis for pro-rata consolidation of those assets and liabilities. Thus, the FASB never embraced the notion of silos as a conceptual basis for consolidation. Outside of certain specialized industry practices that were promulgated by the AICPA and permitted to continue by the FASB, the practice of pro-rata consolidation has been rejected in U.S. GAAP, although it is a common practice in GAAP of certain other countries.

5.1.10.60. Ultimately, the FASB decided that silos should exist only if the entire entity is deemed to be a VIE, and then only if essentially all of the assets, liabilities, and equity of the silo VIE are separate from the overall entity and specifically identifiable. Therefore, divisions, departments, branches, and pools of assets subject to liabilities that provide the creditor recourse only to the specified assets cannot be deemed to constitute a silo if the entity that owns those assets and is the obligor with respect to those liabilities is not itself a VIE. This significantly reduces the likelihood that silos will be identified in practice, as indicated by Example 5.1.

**Example 5.1: Silos**

An asset is leased by a VIE lessor to a lessee. The VIE lessor has multiple leasing transactions with multiple lessees, and the fair value of the leased asset in question represents approximately 40% of the fair value of the VIE’s total assets. The leased asset is financed 100% with nonrecourse debt, and a residual value guarantee is provided by either the lessee or a third party. The guaranteed amount under the guarantee provision is equal to the expected future fair value of the leased property at the inception of the lease. The lessee has a purchase option to acquire the leased property at its future fair value at the end of the lease term (i.e., the purchase option is not a fixed-price purchase option). Because the equity participants in the VIE receive the residual returns associated with any excess of the fair value of the leased asset over the guaranteed residual value at the end of the lease term, the leased asset and related nonrecourse debt would not represent a silo VIE. The lessee would have a variable interest in specified assets of the VIE rather than an interest in the VIE itself or in a silo VIE.

If the purchase option held by the lessee instead had a fixed strike price equal to the residual value guarantee amount, the leased asset, related nonrecourse debt, residual value guarantee, and purchase option would represent a silo
VIE. In that situation, the silo VIE would be evaluated separately from the host VIE, and the silo’s primary beneficiary, if any, would consolidate the silo. When a silo VIE is identified, the variable interest holders of the host VIE must consider the silo not to be part of the host VIE. Consequently, if the host VIE has a primary beneficiary, the assets, liabilities, and noncontrolling interests that it would consolidate would exclude the assets, liabilities, and noncontrolling interests of silo VIEs.

Question 5.1: Assets Financed Entirely with Nonrecourse Debt

Should a specified asset (or group of assets) of a variable interest entity and a related liability secured only by the specified asset or group be treated as a separate variable interest entity if other parties have rights or obligations related to the specified asset or to residual cash flows from the specified asset?

Interpretive Response: For specified assets (and related credit enhancements, if any) to be deemed to represent essentially the only source of payment for specified liabilities or specified other interests in an entity, we believe the guidance in ASC paragraphs 810-10-25-57 and 25-58 requires that generally no more than a trivial amount of the expected losses or expected residual returns associated with those assets may be absorbed or received by parties with variable interests in the host VIE. For this purpose, the host VIE is the VIE that contains the potential silo. Consider, for example, a potential silo with an asset that is financed 100% with nonrecourse debt. The asset is owned by a VIE. If the equity participants in the VIE receive the residual returns associated with any excess of the fair value of the asset over the amount of debt repayments, the asset and related nonrecourse debt would generally not represent a silo VIE.

Question 5.2: Silos That Involve More Than Half of a VIE’s Total Assets

Is it possible for a silo to exist if the fair value of the specified assets (and related credit enhancements, if any) of the potential silo represents more than 50% of the fair value of the VIE’s total assets?

Interpretive Response: Yes. ASC paragraphs 810-10-25-57 and 25-58 indicate that silos arise when interests in specified assets represent essentially the only source of payment for specified liabilities or specified other interests. ASC paragraphs 810-10-25-55 and 25-56 indicate that the fair value of specified assets in which variable interests are held may represent more than half of the total fair value of the entity’s assets (which would cause those

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1 A silo VIE may not necessarily have a primary beneficiary.
interests to be variable interests in the entity). Therefore, we believe that a silo can exist if the fair value of the specified assets that would be included in the silo represents more than 50% of the fair value of the VIE’s total assets.

**Question 5.3: Fixed-Price Purchase Option in an Operating Lease**

Is a fixed-price purchase option in an operating lease a variable interest if the lessor is a VIE but the leased asset represents no more than 50% of the fair value of the lessor’s total assets?

**Interpretive Response:** ASC paragraph 810-10-55-39 indicates that a fixed-price purchase option in an operating lease represents a variable interest in a lessor VIE if (a) the fair value of the leased asset is more than 50% of the fair value of the VIE’s total assets (ASC paragraphs 810-10-25-55 and 25-56), (b) the lessee has a variable interest in the lessor VIE as a whole (other than interests that are insignificant or absorb little or no variability), or (c) the lease transaction represents a silo within the lessor VIE (ASC paragraphs 810-10-25-57 and 25-58). As a result, when the leased asset does not exceed 50% of the fair value of the lessor’s total assets and the lessee does not have a variable interest in the lessor as a whole (or has only variable interests that are insignificant or absorb little or no variability), the purchase option would be considered a variable interest only if the leased asset is held by a silo within the lessor VIE.

**Question 5.4: Effect of a Silo on Whether an Entity Is a VIE**

How does a silo affect the determination of an entity’s expected losses, expected residual returns, and whether the entity is a VIE?

**Interpretive Response:** ASC paragraph 810-10-25-55 states that the expected losses and expected residual returns that apply to interests in specified assets are included in the expected losses and expected residual returns of a VIE only if the interest in specified assets is a variable interest in the VIE. A silo is treated as a separate VIE when the host entity is a VIE under the requirements of ASC Subtopic 810-10, Consolidation – Overall. As a result, we believe the guidance related to interests in specified assets is also relevant to interests in silos. When the fair value of a potential silo’s assets is not more than half of the fair value of the host entity’s total assets (including those of the silo), the interests in the potential silo do not represent variable interests in the host entity when determining whether the entity is a VIE, and the expected losses and expected residual returns that apply to the interests in the silo accordingly should be excluded from the expected losses and expected residual returns of the host entity in determining whether the entity is a VIE regardless of whether the potential silo would be consolidated by one of its variable interest holders.
The guidance in ASC paragraphs 810-10-25-55 to 25-58 creates an artificial residual entity (i.e., the entity that remains after removing the specified assets with a fair value equal to less than half of the fair value of the host entity’s total assets and any related interests in those assets). It is generally more likely that the entity would not be a VIE as a result of evaluating it as a residual entity than otherwise would be the case. The entity’s expected losses and expected residual returns usually will be lower than they otherwise would be as a result of excluding interests in silos and specified assets. This is because interests in silos and specified assets absorb expected losses and expected residual returns with respect to those assets. For example, guarantees of residual values on leased assets in a silo or guarantees of cash collections related to financial assets in a silo absorb expected losses from those assets. Excluding those expected losses from the expected losses of the host entity reduces the amount of equity necessary for it to be considered a voting interest entity. Excluding those interests also may eliminate from consideration, when evaluating the characteristics of the residual entity’s equity, variable interests that would otherwise cause the entity’s equity investors as a group not to be obligated to absorb the entity’s expected losses if they occur or not to have the right to receive the entity’s expected residual returns if they occur, or both.

If the host (residual) entity is a VIE, any silos are removed from the host entity for purposes of determining what parties have a variable interest in the host (the legal entity excluding the silos) and what entity, if any, is its primary beneficiary. Interests in silos do not represent variable interests in the host VIE when determining its primary beneficiary (if any) regardless of whether the fair value of the silo’s assets is more than half of the fair value of the host VIE’s total assets. Consequently, it is more likely that an interest in specified assets that are not part of a silo is a variable interest in the host VIE when there also is a silo that has been excluded from the host (even if that interest in specified assets that are not in a silo was initially excluded when evaluating whether the host entity was a VIE). This is because the silo’s assets are deducted from the host entity’s assets in determining whether the specified assets that are not part of the silo represent more than half of the fair value of the host’s assets (i.e., the host entity’s total assets minus the silo’s total assets).

In response to implementation issues raised in connection with the initial application of ASU 2015-02, the staff in the SEC’s Office of the Chief Accountant (OCA) discussed with members of the Securities Industry and Financial Markets Association (SIFMA) whether equity interests meet the requirements of ASC subparagraph 810-10-15-14(a) to be considered at risk when the equity represents an interest in specified assets rather than a variable interest in the entity under the provisions of ASC paragraph 810-10-25-55.

The SEC staff indicated that it would be appropriate to conclude that equity interests do not qualify to be considered equity at risk when the equity represents an interest in specified assets rather than a variable interest in the entity. For registrants that have previously concluded that equity interests
qualify to be considered equity at risk when the equity represents an interest in specified assets rather than a variable interest in the entity, we understand that the SEC staff would not object to the registrant changing its prior conclusion as part of the adoption of ASU 2015-02.

Given the views expressed by the SEC staff, we believe that equity interests would not qualify to be considered equity at risk unless the equity represents a variable interest in the entity. This is likely to significantly affect the analysis of whether nonregistered series investment funds and similar entities (e.g., segregated or protected cell companies) are VIEs when the individual series investment funds are not considered to be legal entities as discussed in Questions 2.1.20.4 and 2.1.20.5. If all of the entity’s equity represents an interest in specified assets, then there would be no residual entity and no equity at risk. In that situation, we believe the entity would be a VIE because an entity that is not a VIE must have some equity at risk (see Subsection 4.2.50 and Question 4.2.50.3).

Question 5.5: Primary Beneficiary of a Silo

How is the primary beneficiary of a silo VIE determined?

Interpretive Response: Under the requirements of ASC paragraph 810-10-25-57, silos are treated as separate VIEs if the host entity is a VIE. As a result, the same requirements in ASC paragraph 810-10-25-38A that apply in determining the primary beneficiary of a VIE apply in determining the primary beneficiary of a silo. That is, the variable interest holder (if any) in the silo that has (a) the power to direct the activities that most significantly impact the silo’s economic performance and (b) the obligation to absorb losses of the silo that could potentially be significant to the silo or the right to receive benefits from the silo that could potentially be significant to the silo, would be the primary beneficiary of the silo. As with other VIEs, a silo may not necessarily have a primary beneficiary. See Section 6, Primary Beneficiary Determination and Reconsideration, for additional information on how to determine the primary beneficiary of a VIE.

Question 5.6: Effect of a Silo on Consolidation of a Host VIE

How does a silo affect the determination of the primary beneficiary of a host VIE and the determination of the assets, liabilities, noncontrolling interests, and activities of the VIE to be consolidated by the primary beneficiary?

Interpretive Response: Under the requirements of ASC paragraph 810-10-25-57, silos are treated as separate VIEs if the host entity is a VIE. ASC paragraph 810-10-25-57 precludes the primary beneficiary of a host VIE from consolidating a silo within the VIE that is consolidated by another party. Consequently, the assets, liabilities, noncontrolling interests, and activities of
such silos should be excluded from the consolidated financial statements of the host VIE’s primary beneficiary.

We believe the guidance in ASC paragraphs 810-10-25-55 to 25-58 require the variable interest holders in a VIE that contains one or more silos to exclude the silos from the evaluation of which variable interest holder (if any) in the host VIE (i.e., the VIE excluding the silos) meets the requirements in ASC paragraph 810-10-25-38A. That is, the activities that most significantly impact the host VIE’s economic performance and the losses and benefits of the host VIE should be determined without regard to activities, losses, and benefits of silos within the host VIE, thereby affecting which variable interest holder, if any, in the host VIE is deemed to be the host VIE’s primary beneficiary. In addition, although not explicitly addressed by ASC paragraph 810-10-25-57, we believe the assets, liabilities, noncontrolling interests, and activities of silos for which there is no primary beneficiary also should be excluded from the consolidated financial statements of the host VIE’s primary beneficiary (if any). This is consistent with the treatment of silos as separate entities for consolidation purposes when the host (residual) entity is a VIE. In addition, it excludes assets and liabilities in which the host VIE’s primary beneficiary has little or no economic interest from the primary beneficiary’s consolidated financial statements. See Section 6 for additional information about how to determine the primary beneficiary of a VIE.

Question 5.7: Effect of a Silo on Consolidation of a Host (Residual) Entity That Is Not a VIE

How does a silo affect the determination of whether an investor has a controlling financial interest in a host entity that is not a VIE and, if so, the determination of the assets, liabilities, noncontrolling interests, and activities of the entity to be consolidated by the investor?

Interpretive Response: If an entity does not meet any of the characteristics in ASC paragraph 810-10-15-14 after excluding expected losses from variable interests in specified assets, then the host (residual) entity is a voting interest entity and potential silos within the entity are not permitted to be evaluated separately for consolidation by a variable interest holder in the potential silo. The host entity (inclusive of all of its assets and related interests in potential silos) would be evaluated for consolidation under the non-VIE consolidation guidance in ASC Topic 810, Consolidation, in evaluating whether one of the entity’s investors has a controlling financial interest in the entity. If an investor (parent company) has a controlling financial interest in the entity, the parent company would include all of the entity’s assets, liabilities, noncontrolling interests, and activities (including those from potential silos) in its consolidated financial statements.
6. Primary Beneficiary Determination and Reconsideration

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6.1. PRIMARY BENEFICIARY DETERMINATION

6.1.10. Overview

Excerpt from ASC Subtopic 810-10

Consolidation Based on Variable Interests

25-38 A reporting entity shall consolidate a VIE when that reporting entity has a variable interest (or combination of variable interests) that provides the reporting entity with a controlling financial interest on the basis of the provisions in paragraphs 810-10-25-38A through 25-38J. The reporting entity that consolidates a VIE is called the primary beneficiary of that VIE.

25-38A A reporting entity with a variable interest in a VIE shall assess whether the reporting entity has a controlling financial interest in the VIE and, thus, is the VIE’s primary beneficiary. This shall include an assessment of the characteristics of the reporting entity’s variable interest(s) and other involvements (including involvement of related parties and de facto agents), if any, in the VIE, as well as the involvement of other variable interest holders. Paragraph 810-10-25-43 provides guidance on related parties and de facto agents. Additionally, the assessment shall consider the VIE’s purpose and design, including the risks that the VIE was designed to create and pass through to its variable interest holders. A reporting entity shall be deemed to
have a controlling financial interest in a VIE if it has both of the following characteristics:

(a) The power to direct the activities of a VIE that most significantly impact the VIE’s economic performance

(b) The obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE. The quantitative approach described in the definitions of the terms expected losses, expected residual returns, and expected variability is not required and shall not be the sole determinant as to whether a reporting entity has these obligations or rights.

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

25-38B A reporting entity must identify which activities most significantly impact the VIE’s economic performance and determine whether it has the power to direct those activities. A reporting entity’s ability to direct the activities of an entity when circumstances arise or events happen constitutes power if that ability relates to the activities that most significantly impact the economic performance of the VIE. A reporting entity does not have to exercise its power in order to have power to direct the activities of a VIE.

25-38C A reporting entity’s determination of whether it has the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance shall not be affected by the existence of kick-out rights or participating rights unless a single reporting entity (including its related parties and de facto agents) has the unilateral ability to exercise those kick-out rights or participating rights. A single reporting entity (including its related parties and de facto agents) that has the unilateral ability to exercise kick-out rights or participating rights may be the party with the power to direct the activities of a variable interest entity that most significantly impact the entity’s economic performance. These requirements related to kick-out rights and participating rights are limited to this particular analysis and are not applicable to transactions accounted for under other authoritative guidance. Protective rights held by other parties do not preclude a reporting entity from having the power to direct the activities of a variable interest entity that most significantly impact the entity’s economic performance.

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

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

25-38F Although a reporting entity may be significantly involved with the design of a VIE, that involvement does not, in isolation, establish that reporting entity as the entity with the power to direct the activities that most significantly impact the economic performance of the VIE. However, that involvement may indicate that the reporting entity had the opportunity and the incentive to establish arrangements that result in the reporting entity being the variable interest holder with that power. For example, if a sponsor has an explicit or implicit financial responsibility to ensure that the VIE operates as designed, the sponsor may have established arrangements that result in the sponsor being the entity with the power to direct the activities that most significantly impact the economic performance of the VIE.

25-38G Consideration shall be given to situations in which a reporting entity’s economic interest in a VIE, including its obligation to absorb losses or its right to receive benefits, is disproportionately greater than its stated power to direct the activities of a VIE that most significantly impact the VIE’s economic performance. Although this factor is not intended to be determinative in identifying a primary beneficiary, the level of a reporting entity’s economic interest may be indicative of the amount of power that reporting entity holds.

25-38H For purposes of evaluating the characteristic in paragraph 810-10-25-38A(b), fees paid to a reporting entity (other than those included in arrangements that expose a reporting entity to risk of loss as described in paragraph 810-10-25-38J) that meet both of the following conditions shall be excluded:

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

(b) The service arrangement includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm’s length.
Facts and circumstances shall be considered when assessing the conditions in paragraph 810-10-25-38H. An arrangement that is designed in a manner such that the fee is inconsistent with the reporting entity’s role or the type of service would not meet those conditions. To assess whether a fee meets those conditions, a reporting entity may need to analyze similar arrangements among parties outside the relationship being evaluated. However, a fee would not presumptively fail those conditions if similar service arrangements did not exist in the following circumstances:

(a) The fee arrangement relates to a unique or new service.

(b) The fee arrangement reflects a change in what is considered customary for the services.

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

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

(a) Those related to guarantees of the value of the assets or liabilities of a VIE

(b) Obligations to fund operating losses

(c) Payments associated with written put options on the assets of the VIE

(d) Similar obligations such as some liquidity commitments or agreements (explicit or implicit) that protect holders of other interests from suffering losses in the VIE.

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

Before being amended by FASB Accounting Standards Update No. 2009-17 (ASU 2009-17), Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities (originally issued as FASB Statement No. 167, Amendments to FASB Interpretation No. 46(R) (Statement 167)), the guidance in ASC Subtopic 810-10, Consolidation – Overall, generally required a reporting enterprise to consolidate a VIE if the enterprise had a variable interest or interests in a VIE that would absorb the majority of the VIE’s expected losses, receive a majority of the VIE’s expected residual returns, or both. Under this model, reporting enterprises were required to perform a quantitative analysis to determine which entity, if any, was the VIE’s primary beneficiary. ASU 2009-17 amended the existing model by requiring reporting enterprises to instead perform a qualitative evaluation when determining whether they have a variable interest or interests that provides them with a controlling financial interest in (and are, therefore, the primary beneficiary of) the VIE. The previous guidance on majority
exposure to variability of a VIE which continued to apply to certain investment entities under the provisions of FASB Accounting Standards Update No. 2010-10, *Consolidation (Topic 810): Amendments for Certain Investment Funds* (ASU 2010-10) because of the indefinite deferral of the applicability of the consolidation guidance in ASU 2009-17 has been eliminated with the issuance of FASB Accounting Standards Update No. 2015-02 (ASU 2015-02), *Amendments to the Consolidation Analysis*. Therefore, reporting enterprises with interests in certain investment companies that were within the scope of ASU 2010-10 now apply the same guidance on the determination of the primary beneficiary (i.e., the qualitative evaluation described above).

6.1.10.20. Among the FASB’s more significant reasons for the change to a primarily qualitative approach to determining the primary beneficiary of a VIE were that the different approaches and methodologies used to apply the expected losses calculation led to inconsistent application and results for VIEs with similar characteristics,¹ the quantitative analysis often seemed to identify a different primary beneficiary than the party that had the power to direct the activities that most significantly impacted the economic performance of the VIE,² and financial statement users asserted that the quantitative approach did not always capture on a timely basis situations in which enterprises involved with a VIE provided the entity with financial support (including credit and liquidity support).³ The qualitative approach the Board ultimately included in ASU 2009-17 is primarily based on power over the activities that most significantly impact a VIE’s economic performance when the power is held by a party with an economic interest that is significant to the VIE. As discussed further in this section and in the following question, ASU 2009-17’s power concept differs from the majority-voting-control notion that is the basis for consolidation of voting interest entities.

<table>
<thead>
<tr>
<th>Question 6.1.10.1: Comparison of Power for VIEs to Control for Voting Interest Entities</th>
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<tbody>
<tr>
<td>Does having the “power to direct the activities of a VIE that most significantly impact the VIE’s economic performance” as contemplated by ASC subparagraph 810-10-25-38A(a) mean the same thing as having control over a voting interest entity?</td>
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<tr>
<td><strong>Interpretive Response:</strong> No. Although these two concepts are similar and often would result in the same conclusion about which party, if any, has a controlling financial interest in another entity, they do not have the same meaning. For voting interest entities, a reporting enterprise generally has control if it owns more than 50% of the outstanding voting interests. Such enterprises are presumed to have the unilateral ability to control all of the activities that most significantly impact the entity’s economic performance and are therefore not required to specifically identify these activities. However, for</td>
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¹ Paragraph A29 of Statement 167.  
² Paragraph A30 of Statement 167.  
³ Paragraph A31 of Statement 167.
variable interest entities, an enterprise is required to identify the activities and decisions that most significantly impact the VIE’s economic performance from the population of all activities and decisions that may affect the VIE. The primary beneficiary is the enterprise that has the power over these specific activities, rather than all of the VIE’s activities.

**6.1.10.30.** To prevent quantitative tests from being exclusively used in the primary beneficiary determination, ASC subparagraph 810-10-25-38A(b) states that “The quantitative approach described in the definitions of terms expected losses, expected residual returns, and expected variability is not required and shall not be the sole determinant as to whether a reporting entity has these obligations and rights.” [Emphasis added] While the use of quantitative analyses has been de-emphasized, they may be useful in certain situations. For example, a reporting enterprise may find that performing a quantitative analysis is helpful when determining whether it has an obligation to absorb losses or right to receive economic benefits after the adoption of ASU 2009-17. The concept of a reporting enterprise’s obligation to absorb losses or receive economic benefits is discussed in additional detail later in this section.

**Question 6.1.10.2: VIE Determination When an Enterprise Is Not the Primary Beneficiary**

If a reporting enterprise has concluded that it is not an entity’s primary beneficiary, is it still required to evaluate whether that entity is a VIE?

**Interpretive Response:** Yes. Even though a reporting enterprise may not be an entity’s primary beneficiary, ASU 2009-17 has disclosure requirements that apply to non-primary beneficiary variable interest holders of a VIE. See Section 9, Presentation and Disclosure, for additional discussion about ASU 2009-17’s disclosure requirements. However, if a reporting enterprise determines that an entity is not a VIE or that the reporting enterprise does not have a variable interest in the entity, no further analysis or disclosures under ASU 2009-17 are required.

**6.1.10.40.** Under the qualitative approach described in ASC paragraph 810-10-25-38A, a reporting enterprise is deemed to have a controlling financial interest in a VIE (and therefore be its primary beneficiary) if it has both of the following characteristics:

- The power to direct the activities that most significantly impact the VIE’s economic performance (power criterion); and
- The obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE (potentially significant variable interest criterion).

**6.1.10.50.** ASC paragraph 810-10-25-42 requires a decision maker that meets the power criterion to include indirect interests held through related parties (as
defined in ASC paragraph 810-10-25-43) in evaluating whether it meets the potentially significant variable interest criterion. For this purpose, indirect interests held by a related party of the decision maker are only deemed to exist when the decision maker holds an economic interest in the related party. Therefore, if the decision maker holds no interest in the related party, then none of the related party's interest is included in the evaluation even if the related party is under common control with the decision maker (see Subsection 3.5 for the evaluation of whether a decision maker's fee is a variable interest under ASC paragraph 810-10-55-37). If no individual party within a related party group meets both of the conditions in ASC paragraph 810-10-25-38A to be considered a VIE’s primary beneficiary, further evaluation is needed to determine which party in the related party group, if any, should consolidate the VIE. See Section 7, Related Parties and De Facto Agency Relationships, for guidance on the consideration of related parties in determining the primary beneficiary of a VIE.

6.1.10.60. To meet the second criterion in paragraph 6.1.10.40 (potentially significant variable interest criterion), the primary beneficiary is not required to have the obligation to absorb losses and the right to receive benefits that could potentially be significant. For example, if a reporting enterprise has the power to direct the activities that most significantly impact the VIE’s economic performance and has the right to receive returns that could potentially be significant to the VIE (but does not have the obligation to absorb any of the VIE’s losses), the reporting enterprise would be the VIE’s primary beneficiary.

**Question 6.1.10.3: VIE Consolidating Another VIE**

Can the primary beneficiary of a VIE be another VIE if it meets the criteria in ASC paragraph 810-10-25-38A?

**Interpretive Response:** Yes. ASC paragraph 810-10-55-40 indicates that one VIE (VIE 1) is the primary beneficiary of another VIE (VIE 2) if VIE 1 meets the conditions in ASC paragraph 810-10-25-38A to be considered the primary beneficiary. It should also be noted that a VIE can consolidate a silo within another VIE (see guidance in Section 5, Silos).

6.1.20. Primary Beneficiary Must Hold a Variable Interest

6.1.20.10. Note that the VIE’s primary beneficiary is required to hold a variable interest in the VIE. Specifically, ASC paragraph 810-10-25-38 states that “A reporting entity shall consolidate a VIE when that reporting entity has a variable interest (or combination of variable interests) that provides the reporting entity with a controlling financial interest on the basis of the provisions in paragraphs 810-10-25-38A through 25-38J.” Furthermore, the Board noted in paragraph A42 of its Basis for Conclusions to FASB Statement No. Statement 167, Amendments to FASB Interpretation No. 46(R), “....that if an enterprise concludes that its involvement in a variable interest entity does not represent a variable interest, further analysis of whether the enterprise’s obligation to absorb losses or its right to receive benefits could potentially be significant would not be required because
a party cannot be the primary beneficiary of an entity if that party does not hold a variable interest in the entity.” [Emphasis added] Accordingly, reporting enterprises that do not hold variable interests in a VIE will not be required to further evaluate that entity under the VIE provisions of ASC Subtopic 810-10.

**Question 6.1.20.1: Decision-Making Rights Conveyed through a Non-Variable Interest**

If a reporting enterprise holds a variable interest in a VIE, but that variable interest does not convey the power to direct the activities that most significantly impact the VIE’s economic performance, is it precluded from being the primary beneficiary?

**Interpretive Response:** No. While reporting enterprises must have a variable interest to be a VIE’s primary beneficiary, we believe that an enterprise may possess the characteristics in ASC subparagraph 810-10-25-38A(a) through other, non-variable interests. Accordingly, reporting enterprises should consider all of their arrangements and interests in a VIE, including non-variable interests, when evaluating whether they are the VIE’s primary beneficiary. If non-variable interests are excluded from the primary beneficiary determination, reporting enterprises may have opportunities to structure their arrangements with a VIE to avoid consolidation. For example, an enterprise may enter into a voting agreement with other shareholders of a VIE that entitles the enterprise to make decisions about the activities that most significantly impact the VIE’s economic performance. The voting agreement may not convey an obligation to absorb any of the entity’s losses or a right to receive any of its returns. However, if the enterprise has a separate variable interest (such as an equity investment) that obligates it to absorb losses of the VIE or entitles it to receive benefits from the VIE that could potentially be significant to the VIE, then the enterprise would be the VIE’s primary beneficiary.

**Question 6.1.20.2: Decision-Making Rights Conveyed through a Non-Variable-Interest Decision Maker Fee**

If a reporting enterprise directs the activities that most significantly impact the VIE’s economic performance but its decision-making rights are conveyed through a non-variable-interest decision maker fee embedded in an equity interest, is the reporting entity precluded from being the primary beneficiary?

**Interpretive Response:** Yes. As discussed in Question 6.3.30.4, *Applicability of Primary Beneficiary Evaluation for a Decision Maker Whose Fee Is Not a Variable Interest*, if the reporting entity does not have a variable interest, it cannot be the VIE’s primary beneficiary.

For example, assume a general partner holds a 2% equity interest in a limited partnership that is a VIE, and its decision maker fee is embedded in its equity interest. Assume that the general partner's fee does not represent a variable
interest (i.e., the conditions in ASC paragraph 810-10-55-37 have been met; see Section 3.5, Fees Paid to Decision Makers or Service Providers, for additional discussion). One limited partner holds a 98% limited partnership interest. That limited partner lacks substantive participating rights or kick-out rights. The general partner and limited partner are not related parties and neither holds an interest in the other.

The general partner should not consolidate the limited partnership because its decision maker fee (which is conveyed through the equity interest) does not represent a variable interest in the limited partnership. When the fee is not a variable interest (after evaluating it under ASC paragraph 810-10-55-37, in consideration of the terms of the equity), the general partner is deemed to be acting in a fiduciary capacity so the embedded decision maker fee does not cause the general partner to have power to direct the activities that most significantly impact the limited partnership's economic performance (i.e., the power criterion in ASC subparagraph 810-10-25-38A(a)). Therefore, the general partner should not consolidate the limited partnership.

This fact pattern differs from Question 6.1.20.1 because the decision-making rights in this question are deemed to give the holder power (i.e., they are held by the decision maker in the capacity of an agent).

See Question 6.2.80.3: Evaluating Power When the Decision-Maker’s Fee Is Not a Variable Interest, for the limited partner’s consolidation analysis, and Example 7.3.10.1, Determining the Primary Beneficiary in a Common Control Group When the Single Decision Maker’s Fee Is Not a Variable Interest, for additional discussion of this fact pattern when the general partner and the limited partner are related parties under common control.

6.1.30. Multiple Primary Beneficiaries Not Intended

6.1.30.10. Only one reporting enterprise, if any, is expected to be identified as the primary beneficiary of a VIE under the guidance in ASC paragraphs 810-10-25-38A through 25-38J. While the FASB acknowledged that more than one entity could have an obligation to absorb losses or a right to receive benefits that could potentially be significant to the VIE, ASC paragraph 810-10-25-38A states that “…only one reporting entity, if any, will have the power to direct the activities that most significantly impact the VIE’s economic performance.”

6.1.30.20. In paragraph A27 of its Basis for Conclusions to Statement 167, the FASB acknowledged that inconsistent primary beneficiary conclusions may arise because reporting enterprises will need to exercise judgment to determine which enterprise has the power to direct the activities that most significantly impact the VIE’s economic performance. However, the Board concluded that “…if (a) the information used in the assessment is complete and accurate and (b) the analyses of the pertinent factors and characteristics of both variable interests and the variable interest entity are performed using sound judgment, then the risk of inconsistency should be mitigated to an acceptable level.”
6.2. POWER TO DIRECT THE VIE’S MOST SIGNIFICANT ACTIVITIES

6.2.10. Identifying the VIE’s Most Significant Activities

6.2.10.10. As noted in paragraph 6.1.10.40, one of the criteria that must be present for a reporting enterprise to conclude that it is the VIE’s primary beneficiary is that it must have the power to direct the activities that most significantly impact the VIE’s economic performance. These activities may differ by type of entity and judgment will be required when evaluating which activities most significantly impact the VIE’s economic performance.

6.2.10.20. For a reporting enterprise to determine which party meets the power criterion described in ASC subparagraph 810-10-25-38A(a), the enterprise first needs to identify the population of activities that may impact the VIE’s economic performance. Several factors may be considered by the reporting enterprise when identifying these activities, including but not limited to:

- The VIE’s purpose and design;
- Nature and characteristics of the entity’s activities and operations;
- Risk(s) that the VIE was designed to create and pass along to its variable interest holders;
- Rights contained in contractual arrangements and/or the VIE’s governing documents; and
- Rights provided by management, servicing and/or other arrangements.

It is important for reporting enterprises involved with VIEs to establish a process to aggregate the entity’s activities and monitor whether changes to an entity’s activities have occurred, as this may affect the primary beneficiary assessment.

6.2.10.30. After identifying the population of activities that impact the VIE’s economic performance, the reporting enterprise should determine which of these activities most significantly impact the VIE’s economic performance. Depending on the nature of the VIE’s purpose and design, these activities may be identified through a qualitative evaluation (e.g., if the entity only has one or few key activities). A qualitative analysis may entail analyzing the effects of each decision made by variable interest holders on the risks that the VIE was designed to create and pass through to its variable interest holders as well as an enterprise’s expectation related to the decisions that will be made over the VIE’s expected life (e.g., whether they are expected to change upon the occurrence or non-occurrence of an event, etc.). In a speech at the 2010 AICPA National Conference on Current SEC and PCAOB Developments, a member of the SEC staff commented on the staff’s views about whether it is necessary to identify a single activity that most significantly impacts a VIE economic performance. An excerpt from the speech follows:
Excerpt from Speech by Paul A. Beswick

[R]egarding power, we have been asked about the nature of the activities and how a registrant should consider these activities when evaluating who has power over the entity. One piece of advice I have is: when considering the activities that most significantly impact economic performance, it may not be necessary to conclude on which single activity most significantly affects economic performance but rather it may be appropriate to consider a group of activities. This will obviously depend on the structure of the entity and the purpose and design of the entity.

6.2.10.40. However, if the entity is more complex and has several subsets of activities, the reporting enterprise may consider supplementing its qualitative assessment with a quantitative evaluation to determine which activities are most significant. For example, a reporting enterprise may quantify how each of the identified activities affects the VIE’s revenues, margins, net income, cash flows, fair value measurements, and other relevant metrics that measure the entity’s economic performance. Careful consideration should be given by the reporting enterprise to the VIE’s marketing materials, governing documents, margins, contractual documents, and other arrangements when determining which metrics (or combination of metrics) to use when evaluating a particular activity’s effect on economic performance. Different financial metrics may be more significant depending on the nature of the VIE being evaluated. In a speech at the 2010 AICPA National Conference on Current SEC and PCAOB Developments, a member of the SEC staff commented on the staff’s views about the identification of the activities that most significantly impact an entity’s economic performance. An excerpt from the speech follows:

Excerpt from Speech by Wesley R. Bricker

Why is [identifying the scope and duration of the variable interest entity’s activities that are significant to the entity’s economic performance] so important? Well, it is important because identifying the activities of a variable interest entity is central to determining which party has power over those activities. And that’s important because the party with power over those activities has the first of two necessary characteristics of a controlling financial interest.

In one situation, we objected to a view that had attributed activities to a variable interest entity that were not part of the entity, were performed by parties that had no involvement with the entity, and were not related parties or de facto agents of any party that was involved. We did not consider those activities to be the entity’s own activities.

In another situation, we objected to a view that excluded activities that were significant and necessary to the entity accomplishing its purpose and design. An arrangement in this area included an entity designed to hold assets to maturity and fund those assets by rolling over short-term debt financing. The
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.

6.2.20. Entities with Highly Restricted Activities

6.2.20.10. All VIEs, even if their activities or operations are restricted (e.g., operated under pre-defined governing documents, such as a securitization trust), have some form of decision making. In these circumstances, the reporting enterprise should carefully analyze the VIE to determine what the salient activities are and which party has power over these activities. The following considerations, while not all-inclusive, may be relevant when identifying the activities that most significantly impact the economic performance of an entity with highly restricted activities:

- A reporting enterprise does not need to actively use its power to have the power to direct the activities that most significantly impact a VIE’s economic performance. For example, the ability to direct the activities of the VIE only upon the occurrence of certain events or circumstances, may constitute power if the related activities are those that most significantly impact the VIE’s economic performance.
- The reporting enterprise’s involvement in the VIE’s design and structuring may provide insight into that entity’s most significant activities.

In a speech at the 2010 AICPA National Conference on Current SEC and PCAOB Developments, a member of the SEC staff commented on the staff’s views about the identification of the power analysis for entities with a limited range of activities. An excerpt from the speech follows:

**Excerpt from Speech by Wesley R. Bricker**

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.
Question 6.2.20.1: Power Analysis for Entities with Highly Restricted Activities

Is it possible for a variable interest entity to have no activities that significantly impact its economic performance?

Interpretive Response: No. The FASB concluded that “for an entity with a limited range of activities, such as certain securitization entities or other special-purpose entities, power is determined on the basis of who directs the limited range of activities.”\(^4\) For these types of VIEs, the Board included the guidance in ASC paragraph 810-10-25-38F that requires consideration of the involvement an enterprise had with the design of the VIE to determine whether the enterprise has the power to direct the activities that most significantly impact the VIE’s economic performance. The Board reasoned that “involvement [in the design of a VIE] may indicate that the party had the opportunity and the incentive to establish arrangements that result in the party being the variable interest holder with such power.”\(^5\) In addition, the Board included the guidance in ASC paragraph 810-10-25-38G, which states that when “a reporting entity’s economic interest in a VIE…is disproportionately greater than its stated power to direct the [VIE’s] activities…the level of a reporting entity’s economic interest may be indicative of the amount of power that [the] reporting entity holds.”

For entities with a limited range of activities, including those with ongoing activities limited to administrative and similar functions that do not significantly affect the entity’s economic performance, the activities associated with designing the entity are likely the activities that most significantly impact the entity’s economic performance. In general, a party that was involved in the design and structuring of the arrangement, including the selection of the assets to be held by the entity and the classes of variable interests to be issued by the entity, would be expected to have the power through designing the arrangement to direct the activities that most significantly impact the entity’s economic performance if that party has an economic interest that absorbs substantially all of the entity’s economic risks and rewards. When multiple parties are involved in the design of an entity, the economic interests of each party should be analyzed to determine which party, if any, meets the ASC subparagraph 810-10-25-38A(a) power criterion as a result of its involvement in the formation of the entity. We believe a party with an economic interest that absorbs substantially all of the entity’s economic risks and rewards generally would meet the power criterion in these circumstances. To illustrate, consider a resecuritization of real estate mortgage investment conduit securities (RE REMIC) where the RE REMIC vehicle’s ongoing activities are limited to only administrative and similar functions that do not significantly affect the entity’s economic performance. While the ongoing activities are administrative in nature, there are nevertheless activities that significantly impact the RE

\(^4\) Paragraph A38 of Statement 167.
\(^5\) Paragraph A58 of Statement 167.
REMIC’s economic performance. Otherwise, there would have been no business reason to create the RE REMIC. There may be multiple parties involved in the formation of the RE REMIC such as an investment bank, a bank or other investor that holds the subordinated tranche of the structure, an investor in the senior tranche of the structure, and other parties. In general, we believe a party that was involved in the design and structuring of the arrangement, including the selection of the assets to be held by the RE REMIC vehicle and the classes of variable interests to be issued to achieve the desired rating of the senior interests, would be deemed to have the power to direct the activities that most significantly impact the RE REMIC’s economic performance if that party holds an interest that absorbs substantially all of the RE REMIC entity’s economic risks and rewards. Typically, those risks and rewards are concentrated in the subordinated tranche(s) of a RE REMIC structure.

We believe this guidance should not be extended to the evaluation of whether a decision maker or other service provider holds a variable interest in an entity under ASC subparagraph 810-10-55-37(c). That is, variable interests may convey to a decision maker or other service provider more than an insignificant amount of a VIE’s expected losses or expected residual returns without conveying substantially all of the entity’s economic risks and rewards to the decision maker or other service provider. See Question 6.3.30.3 for guidance on evaluating whether a decision maker or other service provider whose fee is a variable interest under ASC paragraph 810-10-55-37 is the primary beneficiary of a VIE.

6.2.30. Identifying the Party with Power

6.2.30.10. Once the reporting enterprise has identified the activity (or activities) that most significantly impacts the VIE’s economic performance, it needs to determine which party has power over these activities. The manner in which power is conveyed to a reporting enterprise depends on the nature of the activities identified. For example, power may be conveyed through voting equity interests, by a management or servicing agreement, and other agreements. As explained in Question 6.1.20.1, power does not necessarily need to be conveyed to a reporting enterprise through a variable interest. In a speech at the 2010 AICPA National Conference on Current SEC and PCAOB Developments, a member of the SEC staff commented on the staff’s views about the sources of power for purposes of identifying the primary beneficiary of a VIE. An excerpt from the speech follows:
Excerpt from Speech by Wesley R. Bricker

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.

Question 6.2.30.1: Meaning of Power for Purposes of VIE Determination versus Primary Beneficiary Determination

Are the activities that most significantly impact an entity’s economic performance the same when (1) determining an entity’s VIE status under ASC subparagraph 810-10-15-14(b)(1) and (2) determining a VIE’s primary beneficiary status under ASC subparagraph 810-10-25-38A(a)?

Interpretive Response: Yes. As indicated in paragraph A63 of the Basis for Conclusions to Statement 167, the FASB decided that the activities that most significantly impact an entity’s performance for purposes of evaluating that entity’s VIE status should be the same as those that would be evaluated when identifying that entity’s primary beneficiary.

6.2.30.20. Similar to the factors that may be considered when identifying the activities that most significantly impact a VIE’s economic performance, the reporting enterprise should evaluate the purpose and design of the VIE and the risks that it was designed to create and pass through to its variable interest holders when determining which entity has power. Examples of risks may include, but are not limited to:

- Interest rate risk;
- Credit risk;
- Foreign currency exchange risk;
- Valuation or price risk;
- Prepayment risk; and
- Operational risk.

6.2.30.30. The reporting enterprise should understand how the risks the entity was designed to create and pass along to its variable interest holders affect the VIE’s economic performance and the activities that relate to each risk. However, there may be situations where certain risks cannot be linked to specific activities that are directed by the variable interest holders. Examples of such situations are illustrated in Cases E and F in ASC paragraphs 810-10-55-147 through 55-171.
6.2.30.40. Reporting enterprises also should consider the characteristics of the entity’s activities and operations, involvement of the variable interest holders in the VIE’s design, the terms of contractual arrangements entered into by the VIE, and the provisions of the VIE’s governing and legal documents. While the FASB indicated in ASC paragraph 810-10-25-38F that the significant involvement of an enterprise with an entity, in isolation, does not establish that enterprise as the party with the power to direct the activities that most significantly impact the economic performance of the entity, such involvement may indicate that the enterprise had the opportunity and the incentive to establish arrangements that result in the enterprise having power. For example, a sponsor may have designed an entity in a manner that provides the sponsor with power as the result of providing the VIE an implicit agreement to fund losses to protect the sponsor’s reputation.

Question 6.2.30.2: Power to Direct the Activities That Affect the Economic Benefits Absorbed by All Variable Interest Holders

When assessing whether an enterprise has power under ASC subparagraph 810-10-25-38A(a), are the activities that convey power those that significantly impact the VIE’s economic performance from the variability that is absorbed only by the holders of equity investments at risk or by the holders of all variable interests?

Interpretive Response: ASC subparagraph 810-10-25-38A(a) does not limit the activities that most significantly impact a VIE’s economic performance to those that only affect the variability absorbed by equity investors. Accordingly, we believe that a reporting enterprise should consider all activities that significantly impact a VIE’s economic performance, regardless of which variable interest holders absorb the variability arising from those activities, when determining which enterprise has power over the VIE. When identifying these activities, the reporting enterprise should evaluate the VIE’s purpose and design as well as the risks and variability that the VIE was designed to create and pass along to the variable interest holders.

Question 6.2.30.3: Power Based on Activities That Occur Outside the VIE

If the activities that most significantly impact a VIE’s economic performance are permitted or required to be performed outside of the VIE, would those activities still be evaluated when determining which party has the power to direct the activities that most significantly impact the VIE’s economic performance?

Interpretive Response: Yes. The entity with the power to direct the activities that most significantly impact the VIE’s economic performance would meet the characteristic of a controlling financial interest under ASC subparagraph 810-10-25-38A(a), regardless of whether those activities occur within or outside of the VIE.
Assume Company A transfers receivables to SPE, which issues cash and beneficial interests to Company A as proceeds. Third parties hold the remaining beneficial interests in SPE, which are senior to those held by Company A. Company A is responsible for servicing the receivables transferred to SPE. As part of its servicing responsibilities, on the default of a receivable, Company A will repurchase the receivable from SPE at par or direct the trustee to sell the receivable. After a repurchase, Company A will continue to service the receivable, including collection activities.

In this transaction, SPE has no ongoing activities. Company A retains substantially all credit risk if any of the receivables it transferred to SPE default. Company A must either direct the trustee to sell the assets, or may choose to purchase the assets from SPE and initiate its own collection process.

The management of defaulted receivables is considered the activity that most significantly impacts the economic performance of SPE. However, the loss mitigation or collection procedures do not occur within SPE itself, as Company A must repurchase the assets from SPE or direct the trustee to sell the receivables. Although these activities occur outside of SPE, Company A would nevertheless have the power to direct the activities that most significantly impact SPE’s economic performance.

This fact set can be distinguished from the warning by the SEC staff not to attribute activities to a VIE that are not part of the entity (see paragraph 6.2.10.40) because the activities in this example are integral to the VIE’s other activities and are performed by an enterprise involved with the VIE. We do not believe an enterprise with a variable interest in a VIE can avoid consolidating the VIE by directly undertaking one or more activities that are integral to the VIE’s other activities and that would significantly affect the VIE’s economic performance if they were engaged in by the VIE. Instead, judgment must be applied in determining the activities that most significantly impact a VIE’s economic performance.

**6.2.40. Contingent Power Considerations**

**6.2.40.10.** A reporting enterprise may obtain the power to direct the activities that most significantly impact a VIE’s economic performance upon the occurrence of specified events or circumstances. This may be more common for entities that have highly restricted activities.

**Question 6.2.40.1: Power Based on Contingent Activities**

How should an enterprise determine whether it meets the ASC subparagraph 810-10-25-38A(a) power criterion if the activities of the VIE that the enterprise has the right to direct are contingent on the occurrence of a specified future event?

**Interpretive Response:** An enterprise must determine whether the activities that are contingent on the occurrence of a specified future event are the
activities that most significantly impact the VIE’s economic performance. This analysis will depend in part on the likelihood that the specified contingent event will occur, and the impact on the VIE’s economic performance of the activities that occur before and after the specified event. If the activities that occur before the specified event are routine or administrative in nature, or otherwise give rise to little variability in the VIE’s economic performance that can be managed through the actions taken by the party directing those activities, the activities that occur after the specified event may have a more significant impact on the VIE’s economic performance than those that occur before the specified event.

The activities of an entity may be carried out in various stages that cannot occur concurrently, and it may be highly uncertain that the current stage of the entity’s activities will be successfully completed thereby allowing the entity to move to the next stage of its planned activities. It may be appropriate in these situations to initially apply the requirements of ASC paragraph 810-10-25-38 based on the particular stage the entity is currently engaged in. Because ASU 2009-17 requires continuous evaluation as to whether an enterprise is the primary beneficiary of a VIE, and the activities that most significantly impact the entity’s economic performance may change over time as new stages begin, the primary beneficiary of the entity may also change over time. We believe the enterprise with power over those activities that currently have the most significant impact on the VIE’s economic performance meets the characteristic in ASC subparagraph 810-10-25-38A(a). An enterprise must continuously evaluate whether the future activities of a VIE have become the activities that most significantly impact the VIE’s economic performance, and the activities that most significantly impact a VIE’s economic performance may change before the occurrence of a specified contingent event. Therefore, there could be a change in power, and the primary beneficiary, before the occurrence of a specified contingent event.

To illustrate, assume that NAW Biotech and HHL Pharmaceutical create a venture intended to develop and distribute a new drug. The venture is structured whereby NAW Biotech has the power to make all required decisions related to research and development activities and HHL Pharmaceutical has the power to make all required decisions related to manufacturing and distribution activities. Given that the drug will require FDA approval, the two stages of the venture (i.e., R&D and manufacturing/distribution) will occur consecutively. In this scenario, while the drug is in the research and development stage, NAW Biotech initially has the power to direct the activities that most significantly impact the VIE’s economic performance. HHL Pharmaceutical, however, has the power to direct the activities that most significantly impact the VIE’s economic performance during the manufacturing and distribution of the drug. If FDA approval becomes probable before it is received, and the manufacturing and distribution activities are expected to have a greater impact on the VIE’s activities than the remaining R&D activities, then HHL Pharmaceutical should conclude that it has the power to direct the
activities that most significantly impact the VIE’s economic performance even though FDA approval has not yet been obtained.

For VIEs with predominantly financial assets, default mitigation activities would not be considered a separate stage in the activities of the VIE because these entities are not designed to operate in stages or phases (i.e., defaults could occur at any time throughout the life of these VIEs).

For example, assume that a VIE’s assets comprise $10 million of 30-year fixed-rate residential mortgage loans. Enterprise A, in its role as the primary servicer, is responsible for the administrative activities associated with servicing the mortgage loans, such as the collection and remittance of cash. Enterprise Z acts as the special servicer and on the delinquency or default of the mortgage loans it will take control of the servicing activities. In its capacity as the special servicer, Enterprise Z is able to make more extensive decisions related to the management of the mortgage loans to recoup the maximum amount under the defaulted loans for the VIE’s investors.

All of the activities of the VIE are pre-specified by the formation documents and no critical decisions are required unless the underlying mortgage loans default. Accordingly, the activities that most significantly impact the economic performance of the VIE are those that may be made by Enterprise Z. The activities directed by Enterprise A are not significant to the VIE’s economic performance. ASC paragraph 810-10-25-38B states, “A reporting entity does not have to exercise its power in order to have power to direct the activities of a VIE.” Therefore, even though the special servicing activities directed by Enterprise Z only arise on the occurrence of a specified contingent event (the delinquency or default of the mortgage loans), those activities provide Enterprise Z with the power to direct the activities that most significantly impact the economic performance of the VIE.

6.2.50. Consideration of Protective Rights

6.2.50.10. While Question 6.2.40.1 illustrates a situation in which a reporting enterprise’s ability to direct the VIE’s most significant activities upon the occurrence of specified events represents power, enterprises should distinguish between rights that convey power and rights that are protective in nature. ASC Subtopic 810-10 provides the following description of protective rights:

**Excerpt from ASC Subtopic 810-10**

25-10 Noncontrolling rights (whether granted by contract or by law) that would allow the noncontrolling shareholder or limited partner to block corporate or partnership actions would be considered protective rights and would not overcome the presumption of consolidation by the investor with a majority voting interest or limited partner with a majority of kick-out rights through voting interests in its investee. The following list is illustrative of the protective rights:
that often are provided to the noncontrolling shareholder or limited partner but is not all-inclusive:

(a) Amendments to articles of incorporation or partnership agreements of the investee

(b) Pricing on transactions between the owner of a majority voting interest or limited partner with a majority of kick-out rights through voting interests and the investee and related self-dealing transactions

(c) Liquidation of the investee in the context of Topic 852 on reorganizations or a decision to cause the investee to enter bankruptcy or other receivership

(d) Acquisitions and dispositions of assets that are not expected to be undertaken in the ordinary course of business (noncontrolling rights relating to acquisitions and dispositions of assets that are expected to be made in the ordinary course of business are participating rights; determining whether such rights are substantive requires judgment in light of the relevant facts and circumstances [see paragraphs 810-10-25-13 and 810-10-55-1])

(e) Issuance or repurchase of equity interests.

6.2.50.20. Protective rights that are contingent on the occurrence of specified events or circumstances do not convey power or prevent another reporting enterprise from consolidating the VIE.

Question 6.2.50.1: Distinguishing Protective Rights from Rights That Convey Power

How should an enterprise distinguish protective rights from rights that convey the power to direct the activities that most significantly impact the economic performance of a VIE even though they are exercisable only on the occurrence of a specified event or events (sometimes referred to as contingent power)?

Interpretive Response: Protective rights pertain to activities that do not most significantly impact a VIE’s economic performance. Power that is exercisable only on the occurrence of a specified event or events is more likely to represent a protective right when the VIE is an operating entity with a wide range of activities than when the VIE has a very limited range of activities (such as many securitization or other special-purpose entities). When the VIE’s range of activities is limited, there is a greater likelihood that the activities that occur before the specified event are routine or administrative in nature, or otherwise give rise to very little variability in the VIE’s economic performance that can be managed through the actions taken by the party directing those activities. In these circumstances, the activities that occur after the specified event are likely to have a more significant impact on the VIE’s economic performance than those that occur before the specified event and power that is
exercisable only on the occurrence of the specified event or events is more likely to meet the ASC subparagraph 810-10-25-38A(a) power criterion based on the guidance in ASC paragraph 810-10-25-38B.

A right that allows its holder to take possession of all of the assets of an operating business on a material adverse change in the operations of the business, like the right described in Case I at ASC paragraphs 810-10-55-199 through 55-205, would represent a protective right if there is a low likelihood that the specified contingent event will occur and the VIE’s economic performance is most significantly impacted by the activities that occur before the specified event. The activities that occur after the specified event are likely to have a less significant impact on the VIE’s economic performance than those that occur before the specified event. That is, the right to liquidate the assets of a business on a default or a material adverse change in the operations of the business would not likely be the activity that most significantly impacts the economic performance of the business. Rather, this right is similar to a creditor’s collateral right and represents a protective right. While a protective right does not cause its holder to be considered the primary beneficiary of a VIE, the FASB emphasized in paragraph A38 of the Basis for Conclusions to Statement 167 that a right initially considered a protective right could cause its holder to meet the condition in ASC subparagraph 810-10-25-38A(a) at a later date.

6.2.60. Effect of Kick-Out and Participating Rights on Power

6.2.60.10. When determining whether a reporting enterprise has power, ASC paragraph 810-10-25-38C states that a reporting enterprise’s determination should not “…be affected by the existence of kick-out rights or participating rights unless a single reporting entity (including its related parties and de facto agents) has the unilateral ability to exercise those kick-out rights or participating rights.” A single reporting enterprise may be the party with the power to direct the activities of a VIE that most significantly impact its economic performance if the reporting enterprise has the ability to unilaterally kick out the party that currently has power.

EVALUATION OF KICK-OUT RIGHTS

6.2.60.20. In its Basis for Conclusions to Statement 167, the FASB acknowledged that requiring kick-out rights to be held by a single party (i.e., unilateral kick-out rights) to overcome power otherwise attributable to the party that would be removed upon the exercise of those rights, was inconsistent with other U.S. GAAP, including other areas of unamended ASC Subtopic 810-10 and ASC Section 810-20-25. (Note that ASC Section 810-20-25 has now been superseded for the most part by ASU 2015-02. Paragraphs in ASC Subtopic 810-20, Consolidation – Control of Partnerships and Similar Entities, that were not superseded as a result of the issuance of ASU 2015-02 have been moved to ASC Subtopic 810-10.) Under the provisions of ASC Section 810-20-25 before being superseded by ASU 2015-02, kick-out rights were considered substantive
when they could be exercised by a simple majority of the limited partners (rather than a single party) that were not under common control with, or acting on behalf of, the general partner. However, at the time Statement 167 was issued, the Board believed that if the guidance related to kick-out rights for VIEs was consistent with the guidance on kick-out rights in ASC Section 810-20-25 for voting interest entities, enterprises might too easily structure VIEs in a manner that would allow them to conclude that no single enterprise had power over the VIE. The Board also indicated that this inconsistency was acceptable because it believed kick-out rights were rarely exercised in practice. Therefore, Statement 167 required kick-out rights and participating rights to be ignored when determining an entity’s VIE status and a VIE’s primary beneficiary (if any) unless they were unilaterally exercisable.

6.2.60.30. ASU 2015-02 reverts to a simple majority or lower threshold of kick-out rights held by limited partners as one of the characteristics to determine whether a limited partnership or similar entity is a VIE. Conversely, it retains the requirement for kick-out rights or participating rights held by other parties to be ignored unless they are unilaterally exercisable by a single party or related party group in determining a VIE’s primary beneficiary. Thus, ASU 2015-02 creates a new inconsistency in how kick-out rights and participating rights are evaluated for purposes of determining whether an entity is a VIE in ASC subparagraph 810-10-15-14(b)(1)(ii) (i.e., exercisable by a simple majority) and for purposes of determining the primary beneficiary of a VIE in ASC subparagraph 810-10-25-38A(a) (i.e., unilaterally exercisable by a single party or related party group). As described in paragraph BC51 of the Basis for Conclusions to ASU 2015-02, the Board reaffirmed its concern “… that a reporting entity might only provide kick-out rights or participating rights to a simple majority of variable interest holders as a means to achieve an accounting outcome, rather than substantive rights for the purposes of governance.”

6.2.60.40. To identify whether substantive unilateral kick-out rights are present, the reporting enterprise should first determine which enterprise has the power to direct the activities that most significantly impact the VIE’s economic performance and then whether any party has the unilateral right to remove that enterprise. This process generally requires careful review and evaluation of the VIE’s governing documents and other contractual arrangements to determine whether any particular rights represent kick-out rights. For example, there may be circumstances where a substantial investor in an asset-backed financing vehicle must affirm in writing the appointment of the entity’s servicer (deemed to control the entity’s most significant activities) on a monthly basis. In this situation, failure to affirm the servicer would result in the servicer’s removal. While the right to affirm the servicer on a monthly basis is not described as a kick-out right in the contractual arrangements or governing documents, it should be considered one.

6.2.60.50. Reporting enterprises should also consider the nature of the parties that hold the unilateral kick-out rights. For example, kick-out rights may be provided to an equity investor based on its right to control the VIE’s board of directors, a significant investor in a VIE’s non-equity instruments, a creditor, or
other stakeholder. Understanding the entity’s purpose and design may facilitate identification of these parties because certain enterprises may have a particular motivation to hold kick-out rights (e.g., a significant investor in an asset-backed debt issuance may want the ability to kick out the servicer (or special servicer) if certain delinquencies or default events occur). Enterprises should evaluate whether parties holding kick-out rights are acting as an agent of another enterprise. In general, substantive unilateral kick-out rights over a VIE’s decision maker would be expected to provide power to the party that is ultimately able to direct the exercise of those rights.

**Question 6.2.60.1: Kick-Out Rights Exercisable by a Board of Directors**

Can a board of directors be evaluated as one party when considering whether one party has the unilateral ability to exercise substantive kick-out rights when determining the primary beneficiary of a VIE?

**Interpretive Response:** No. A board of directors functions solely as a fiduciary of the shareholders. A board of directors simply is a mechanism for shareholders to exercise their rights. A board does not create new rights for shareholders; rather it is a reflection of, or pass-through mechanism for, the exercise of the shareholders’ rights. Accordingly, we believe that a board of directors cannot be considered to have power for purposes of analyzing an entity under the requirements of ASC Subtopic 810-10. A board of directors comprises more than one individual; therefore, kick-out rights exercisable by a board should not be considered when determining whether one party has a unilateral ability to exercise substantive kick-out rights unless a single shareholder (or group of related party shareholders) has the unilateral ability to select the requisite number of board members necessary to control the entity or the power to direct the board’s actions.

When the board of directors directly makes decisions about activities that most significantly impact the economic performance of a VIE, the shareholders (for whom the board of directors is acting in a fiduciary capacity) collectively have that power. If the entity is a VIE, a single shareholder (or group of related party shareholders) with the unilateral ability to select the members of such a board would be considered to have the power to direct the activities that most significantly impact the economic performance of the VIE.

**Question 6.2.60.2: Disposal of Substantive Kick-Out Rights**

Can a reporting enterprise dispose of its substantive kick-out rights by transferring them to another enterprise or by agreeing not to exercise them?

**Interpretive Response:** It depends on the particular facts and circumstances, including whether the transaction entered into by the reporting enterprise to dispose of its kick-out rights is substantive in nature, as contemplated in ASC paragraph 810-10-15-13A. For example, a reporting enterprise’s pledge not to
exercise its kick-out rights or transfer of the kick-out rights to a third party for no consideration would generally not be considered substantive, because there is no apparent business reason or purpose for the transaction other than to avoid consolidation. On the other hand, a reporting enterprise may have a valid business reason for transferring its kick-out rights to another party. For example, a transaction whereby an asset-backed securitization entity’s sponsor transfers its kick-out rights (e.g., the right to kick out the entity’s special servicer) to a new institutional investor in connection with that investor’s purchase of securities issued by the entity, may be considered substantive. In this example, the institutional investor wanted the power over the party that directs the VIE’s most significant activities as a condition to making a large investment.

LIQUIDATION AND WITHDRAWAL RIGHTS

6.2.60.60. Reporting enterprises should consider substantive dissolution or liquidation rights the equivalent of substantive kick-out rights. ASU 2015-02 updated the VIE definition of kick-out rights to include the right to dissolve or liquidate the VIE without cause. In rare instances withdrawal rights also may implicitly require liquidation of an entity and therefore function similar to substantive kick-out rights. A scenario in which a withdrawal right would be similar to a substantive kick-out right is when an investor holds a substantial portion of the investment interests in a fund with illiquid investments such that a withdrawal by the investor of its investment in the fund would compel the fund to liquidate all of its investments to satisfy the investor’s withdrawal right, provided that there were no significant barriers to the exercise of that right. Withdrawal rights that do not either explicitly or implicitly require dissolution or liquidation of the entity would not be considered similar to a substantive kick-out right. See also Questions 4.2.50.11 and 4.2.50.12.

Question 6.2.60.3: Dissolution and Liquidation Rights

Should a right to dissolve or liquidate an entity be evaluated differently than a kick-out right or participating right in determining which party (if any) has the power to direct the activities that most significantly impact a VIE’s economic performance?

Interpretive Response: No. With the issuance of ASU 2015-02, the VIE and voting interest entity models both equate dissolution (liquidation) rights with kick-out rights. However, under the VIE model’s primary beneficiary criteria, dissolution (liquidation) rights must be unilaterally exercisable by a single enterprise or related party group and must be substantive to be considered in the analysis of which party (if any) has the power to direct the activities that most significantly impact a VIE’s economic performance.

An enterprise or related party group that holds a unilaterally-exercisable dissolution (liquidation) right does not need to receive the VIE’s underlying assets on exercise of the right for the dissolution (liquidation) right to be
considered substantive. Like a substantive participating right, a substantive dissolution (liquidation) right need only take power away from another party that would otherwise have it (e.g., a general partner, managing member, or decision maker). It need not necessarily convey power over the VIE to its holder.

If an enterprise or related party group that holds a substantive, unilaterally-exercisable, dissolution (liquidation) right is not entitled to receive the VIE’s underlying assets on exercise of the right, the enterprise or related party group generally would not be deemed to have the power to direct the activities that most significantly impact the VIE’s economic performance consistent with our views about substantive participating rights. However, the existence of these rights would preclude another enterprise from having the power to direct the activities that most significantly impact the VIE’s economic performance. All relevant facts and circumstances should be considered to determine the activities that most significantly impact a VIE’s economic performance and whether a single party has the power to direct those activities. For example, in certain unusual circumstances the liquidation of a VIE’s assets could be the activity that most significantly impacts the VIE’s economic performance, and the holder of a substantive unilaterally-exercisable liquidation right may be the VIE’s primary beneficiary in that situation.

This guidance differs from the evaluation of participating rights under ASC subparagraph 810-10-15-14(b)(1).

KICK-OUT RIGHTS MUST BE SUBSTANTIVE

6.2.60.70. For kick-out rights to overcome power that would otherwise be held by the party that can be removed upon their exercise, they must be considered substantive, meaning that there must be no significant barriers to their exercise. The party with kick-out rights must have the ability to exercise those rights if they choose to do so. While ASC Subtopic 810-10 does not provide specific examples of barriers to exercise, we believe that all relevant facts and circumstances should be considered in evaluating whether there are barriers to exercise of the rights that make them nonsubstantive. In making this evaluation, the factors included in ASC paragraph 810-10-25-14A should be considered as a starting point. That guidance specifies that the following factors may indicate that kick-out rights are not substantive:

- Kick-out rights subject to conditions that make it unlikely they will be exercisable. For example, conditions that narrowly limit the timing of the exercise or would be economically unfavorable for the party holding the rights.
- Financial penalties or operational barriers associated with dissolving (liquidating) the entity or replacing the decision maker being kicked out that would act as a significant disincentive for dissolution (liquidation) or removal.
• The absence of an adequate number of qualified replacement decision makers or the lack of adequate compensation to attract a qualified replacement.

• The absence of an explicit, reasonable mechanism by which the party holding the rights can exercise those rights.

• The inability of the party holding the rights to obtain the information necessary to exercise them.

6.2.60.80. In addition, barriers to exercise may be different for kick-out rights as compared with barriers for liquidation rights when assessing whether the rights are substantive. The FASB indicated in paragraph A48 of the Basis for Conclusions to Statement 167 that it did not want the preceding factors to be considered all-inclusive. Rather, all relevant facts and circumstances should be considered in determining whether kick-out rights or liquidation rights are substantive.

EVALUATION OF PARTICIPATING RIGHTS

6.2.60.90. Participating rights, as contemplated in ASC paragraph 810-10-25-38C, were defined in paragraph A51 of the Basis for Conclusions to Statement 167 as “the ability to block the actions through which an enterprise exercises the power to direct the activities of a variable interest entity that most significantly impact the entity’s economic performance.” In ASU 2015-02, the FASB amended the definition of participating rights as follows (amendments underlined) “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.” The FASB noted in paragraph BC55 of the Basis for Conclusions to ASU 2015-02 that the definition of participating rights was amended to enhance readability, not to change the meaning or interpretation of the definition. The FASB decided that participating rights can provide a constraint on the decision-making ability of a reporting enterprise in a manner similar to kick-out rights and should therefore be subject to the same restrictions as kick-out rights. Said another way, the Board decided that the determination of the primary beneficiary should not be affected by participating rights unless a single enterprise (including its related parties and de facto agents) has the unilateral ability to exercise such participating rights and such rights provide the reporting enterprise with the ability to block decisions related to the activities that most significantly impact the VIE’s economic performance.
Question 6.2.60.4: Evaluating Whether the Holder of Participating Rights Has Power

Does a single enterprise or related party group with the unilateral ability to exercise substantive participating rights have the power to direct the activities that most significantly impact a VIE’s economic performance?

Interpretive Response: Not necessarily. Participating rights often do not provide their holder with the right to propose decisions or to unilaterally make decisions. Rather, they generally provide their holder with the right to approve decisions that are proposed by another party. Thus, participating rights generally require at least two independent parties to agree to specified decisions that are made about an entity’s activities. As a result, these rights may not give their holder the power to direct the activities that most significantly impact a VIE’s economic performance.

PARTICIPATING RIGHTS MUST BE SUBSTANTIVE

6.2.60.100. The FASB provided no examples of what may constitute substantive participating rights for purposes of evaluating the power criterion in ASC subparagraph 810-10-25-38A(a). However, the guidance in ASC paragraph 810-10-25-11 may serve as a starting point when evaluating whether substantive participating rights are present. Specifically, for voting interest entities, participating rights would include, but not be limited to, the ability to participate in such decisions as:

- Selecting, terminating, and setting the compensation of the management responsible for implementing the policies and procedures.
- Establishing the operating and capital decisions, including budgets, in the ordinary course of business.

These rights may also represent participating rights for some variable interest entities if the activities subject to these powers most significantly impact the VIE’s economic performance. This is more likely to be true for VIEs with substantive ongoing business operations than for other VIEs. However, all facts and circumstances should be considered, including the level at which these powers operate. For example, the ability to approve operating and capital budgets may not remove power from the servicer of an asset management VIE if significant decisions about default mitigation cannot be significantly influenced through the budget process. Ultimately, a substantive participating right in a VIE must provide the entity holding the right to participate in making the decisions that most significantly impact the VIE’s economic performance.
Question 6.2.60.5: Evaluating Whether Kick-Out Rights and Participating Rights Are Substantive

Do all kick-out rights or participating rights unilaterally exercisable by a single enterprise affect the determination of which party has the power to direct the activities of a VIE?

Interpretive Response: No. Consistent with the guidance in ASC paragraph 810-10-15-13A, kick-out rights or participating rights unilaterally exercisable by a single enterprise must be substantive to affect the determination of which party has the power to direct the activities of a VIE. The factors included in ASC paragraph 810-10-25-14A should not be considered all-inclusive when determining the substance of kick-out rights.6

Although the FASB intends for all terms and conditions of kick-out rights or participating rights to be considered when determining whether these rights are substantive, we believe that the guidance in ASC paragraph 810-10-25-14A provides an appropriate starting point for evaluating the substance of kick-out rights and participating rights. However, other factors not contemplated by ASC paragraph 810-10-25-14A would need to be considered in some situations.

Sometimes the evaluation of the factors in ASC paragraph 810-10-25-14A may not be straightforward. For example,

- A general partner that can be removed by a kick-out right held by an unrelated party may have a right to share in a portion of the return related to investments of the partnership that the general partner selected before being removed, when the kick-out right is exercised. Whether the return-sharing provision represents a barrier to the removal of the existing general partner may depend on, among other things, whether the partnership is designed to continue acquiring investments after the removal of the existing general partner, whether replacement of the general partner would reduce the level of return to which the limited partners would otherwise be entitled, and whether the return-sharing provision would make it more difficult to attract a replacement general partner (who would be subject to the same provision in the event of removal) than it otherwise would be without the return-sharing provision.

- A dispute resolution mechanism might exist, such as a buy-sell provision under which a limited partner (party with participating rights) has the right to establish a price at which the general partner must either (1) elect to purchase the limited partner’s interest or (2) sell its (general partner’s) interest to the limited partner if the limited partner and general partner cannot agree on the operating budget of the partnership. ASC subparagraph 810-10-25-13(f) states:

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6 Paragraph A48 of Statement 167.
An owner of a majority voting interest or limited partner with a majority of kick-out rights through voting interests who has a contractual right to buy out the interest of the noncontrolling shareholder or limited partner in the investee for fair value or less shall consider the feasibility of exercising that contractual right when determining if the participating rights of the noncontrolling shareholder or limited partner are substantive. If such a buyout is prudent, feasible, and substantially within the control of the majority owner, the contractual right to buy out the noncontrolling owner or limited partner demonstrates that the participating right of the noncontrolling shareholder or limited partner is not a substantive right.

In some situations, it will be clear that a dispute resolution mechanism such as the buy-sell provision causes the participating rights of the limited partner not to be substantive under the guidance in ASC subparagraph 810-10-25-13(f). In other situations, for example, because of the effect of preferences to profits or cash flows on the value of the general and limited partners’ interests, it may be unclear that the price established under a buy-sell provision would be fair value or less. However, when the dispute resolution mechanism related to a limited partner’s participating rights provides only three choices for the limited partner (1) accept the decisions of the general partner, (2) dispose of its limited partner interest, or (3) acquire the general partner’s interest, we believe the participating rights would not be considered substantive. In effect, the dispute resolution provision is a significant barrier to the limited partner’s ability to exercise the participating rights.

While the guidance on participating rights herein is discussed in the context of limited partnerships, the guidance also applies to entities that are not limited partnerships.

In addition, the analysis for VIEs with respect to substantive participating rights in ASC subparagraph 810-10-25-38A(a) differs from ASC subparagraph 810-10-15-14(b)(1). See Question 4.2.50.4.

CONSIDERATION OF CALL OPTIONS

6.2.60.110. ASC Subtopic 810-10 does not address whether call options may provide their holder with power to direct the activities that most significantly impact a VIE’s economic performance. However, in some situations a call option may function similar to a substantive kick-out right as discussed in the following question.
**Question 6.2.60.6: Effect of Call Options and Forward Contracts on Power Analysis**

Does a call option on another party’s variable interest in a VIE provide the holder of the call option with the ability to direct the activities that most significantly impact the VIE’s economic performance?

Interpretive Response: In some situations, ASC paragraph 810-10-25-38B is clear that an enterprise does not need to exercise its power to have power to direct the activities of the entity. The Board reasoned that “if the activities that most significantly impact the economic performance of a variable interest entity would only need to occur when certain circumstances arise or certain events happen, then the party that has the power to direct those activities still has power over the entity...an enterprise does not have to exercise its power to have power to direct the activities of an entity.”

In addition, kick-out rights that may be exercised unilaterally by a single enterprise may convey to their holder the power to direct the activities that most significantly impact a VIE’s economic performance because these rights may effectively give their holder the same rights as the party that would be removed on exercise of the kick-out rights.

An entity must currently have the ability to exercise its power to meet the characteristic in ASC subparagraph 810-10-25-38A(a) and a call option may not convey to its holder the current ability to exercise power until the call option is exercised. However, if a call option is currently exercisable and there are no significant barriers (including financial barriers) to its exercise, it may currently provide the holder with the power to direct the activities that most significantly impact the VIE’s economic performance. For example, a deep-in-the-money call option exercisable for little consideration, generally should be evaluated like other kick-out rights that are exercisable by a single party or related party group when applying ASC Subtopic 810-10. Similarly, a lender may receive warrants in a troubled-debt restructuring that, if exercised, would give the lender the ability to control the borrower. If the warrants are deep-in-the-money and exercisable for little consideration, we believe they should be evaluated like other kick-out rights that are exercisable by a single party when applying ASC subparagraph 810-10-25-38A(a).

The holder of a call option that is not currently exercisable, a call option that is contingently exercisable, or a forward contract, generally would not currently have the ability to direct the activities that most significantly impact the VIE’s economic performance.

To illustrate, assume that KKB Venture is established by two equity investors (RBM and MDM) who jointly control the venture. RBM holds a currently exercisable call option on MDM’s equity interest that is deep-in-the-money and exercisable for little consideration. We believe that the call option should be

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7 Paragraph A38 of Statement 167.
8 Paragraph A45 of Statement 167.
evaluated like a kick-out right that conveys to RBM the power to direct the activities that most significantly impact the economic performance of KKB Venture (i.e., power is not shared). However, if RBM’s call option is not currently exercisable (e.g., is not exercisable for five years), or is not exercisable unless MDM is acquired by a third party, the call option generally would not affect the current analysis of power. When the call option becomes exercisable, its effect on the primary beneficiary evaluation would need to be reassessed.

6.2.70. Shared Power Considerations

6.2.70.10. The FASB acknowledged that there may be circumstances where a reporting enterprise may conclude that the power is shared among multiple unrelated parties so that no one party has the power to direct the activities that most significantly impact the VIE’s economic performance. In these situations, no primary beneficiary exists. ASC paragraph 810-10-25-38D states that power is shared if two or more unrelated parties together have the power to direct the activities of the VIE that most significantly impact its economic performance and those activities require the consent of each party (i.e., one party cannot unilaterally make decisions related to the entity’s most significant activity).

6.2.70.20. The FASB noted in paragraph A55 of the Basis for Conclusions to Statement 167 that it believes obtaining the consent of each party is necessary because this characteristic would be most indicative of a group of parties that had agreed to share power. However, the Board noted that the mere existence of a consent requirement would not be sufficient to conclude that shared power exists. Rather, the Board believes that reporting enterprises should carefully evaluate the VIE’s governing documents to ascertain whether such consent provisions are substantive (e.g., what the consequences are if consent is not given). In a speech at the 2010 AICPA National Conference on Current SEC and PCAOB Developments, a member of the SEC staff commented on the staff’s views about shared power analyses. An excerpt from the speech follows:

**Excerpt from Speech by Wesley R. Bricker**

One of the more frequently arising points that we have considered is whether power in a particular instance is shared among multiple unrelated parties, such that no one party has the power to direct the activities of the entity that most significantly impact the entity’s economic performance. The guidance is clear that power is shared if - and only if - two or more unrelated parties together have the power to direct the activities of a variable interest entity that most significantly impact the variable interest entity’s economic performance and if decisions about those activities require the consent of each of the parties sharing power. We approach assertions that power is shared with a healthy dose of skepticism. The guidance sets up a model where both parties together have the power to direct the activities, with the consent of the other. It is
important to read those words plainly and in a manner reflecting a concern that the concept could be interpreted more broadly than intended.

So, just to describe two situations at different ends of a spectrum: on the one end, we objected to a determination that power was shared between a sponsor and various unrelated investors where a sponsor transferred assets and the entity’s investors purchased interests backed by those assets without any demonstration that the sponsor and investors agreed to share power over the entity’s activities. On the other end, we also considered determinations that power was shared between two parties, where each party demonstrated that they together shared power.

6.2.70.30. Reporting enterprises should carefully scrutinize provisions that address circumstances that may arise when the parties sharing power cannot reach agreement on a decision relative to the VIE’s activities (commonly referred to as deadlock provisions). If one of the parties is able to overcome the deadlock by casting a tie-breaking vote, that party may be the VIE’s primary beneficiary because power is not truly being shared.

Example 6.2.70.1: Illustration of a Shared Power Scenario

BMW Beverages (BMW) and CKW Drinks (CKW) are unrelated enterprises that establish an entity (BC) to manufacture, distribute, and sell a soft drink. BMW, a soft drink manufacturer and distributor, is responsible for BC’s manufacturing activities. CKW, also a soft drink manufacturer and distributor, is responsible for distributing the soft drink. BMW and CKW each have 50% of the voting rights and each appoint 50% of BC’s board of directors. All decisions about the manufacturing, selling, and distribution of the soft drink, which are the activities deemed to most significantly impact BC’s economic performance, require the consent of both BMW and CKW. Based on a consideration of these particular facts and circumstances, BC does not have a primary beneficiary because the decisions about the activities that most significantly impact its economic performance are shared by BMW and CKW.

Question 6.2.70.1: Alignment of Power and Economic Interests

For multiple unrelated parties to share power, must each party have a similar level of economic interest in the entity?

Interpretive Response: Not necessarily. All facts and circumstances must be considered in evaluating whether power is shared and whether a party has a greater or lesser degree of power over the activities that most significantly impact an entity’s economic performance than the proportion of its economic interest to the entity’s total economic interests. The FASB believes that an increased level of skepticism is needed where a party’s economic interest in a
VIE is disproportionately greater than its stated power. Accordingly, consideration should be given to situations in which a party’s economic interest is disproportionate relative to its stated power to direct the activities that most significantly impact the entity’s economic performance. However, proportionate economic interests are not required to be held by unrelated parties that share power, if each party’s stated power over a variable interest entity is substantive.

**Question 6.2.70.2: Effect of a Managing Member on a Shared Power Analysis**

What is the effect on a shared power analysis when one of the parties with shared power is also the managing member?

**Interpretive Response:** It depends on whether the decisions that can be made by the managing member without consent pertain to the activities that significantly impact the VIE’s economic performance. If so, power would not be deemed to be shared. If not, power may be deemed to be shared.

Many joint venture agreements appoint one of the members as the managing member to run the day-to-day operations of the joint venture. The managing member is not required to consult with the other venturer on a daily basis; however, the managing member is required to carry out the annual operating plan as approved by the board of directors (which has equal representation). The assessment of shared power should focus on whether the decisions about the activities that most significantly impact the entity’s economic performance are made with the consent of each member or made unilaterally by the managing member. Assuming that all activities that significantly impact the entity’s economic performance are agreed on in the operating plan, we believe it would be appropriate to conclude that the managing member is carrying out the wishes of the board of directors (in an agency capacity), and therefore shared power may be present. However, if decisions about the activities that most significantly impact the entity’s economic performance may be made unilaterally by the managing member, power is not shared and the managing member would be considered the primary beneficiary assuming that it holds a variable interest that also meets the significant economic interest criterion in ASC subparagraph 810-10-25-38A(b).

Assume two members (KKB and RBM) form HHL Venture to develop, build, and distribute super widgets. KKB is the managing member of the venture. Although all other decisions of HHL Venture require the consent of both KKB and RBM, KKB as managing member unilaterally makes all decisions related to distribution activities. Distribution of the super widgets is an activity that significantly impacts the economic performance of the entity, and because the decisions related to those activities are made unilaterally by KKB as managing

9 Paragraph A35 of Statement 167.
member, power over HHL Venture is not shared by KKB and RBM. In this example, KKB would be the party with the power to direct the activities that most significantly impact HHL Venture's economic performance.

6.2.70.40. There may be circumstances where multiple unrelated parties direct the activities that most significantly impact a VIE’s economic performance and the nature of the activities directed by each party is the same, but the parties do not need each other’s consent before making decisions related to those activities. ASC paragraph 810-10-25-38D requires such reporting enterprises to identify the party with the power over the majority of those activities as the VIE’s primary beneficiary. Determining which of multiple parties has power over the majority of a VIE’s activities may be challenging and will require reporting enterprises to fully consider all relevant facts and circumstances. However, if no party has power over the majority of a VIE’s activities when multiple parties make decisions about activities of the same nature, then the VIE would have no primary beneficiary.

6.2.70.50. If the activities that impact the VIE’s economic performance are directed by multiple unrelated parties, and the nature of these activities differ, shared power does not exist. In this situation, the reporting enterprise must first identify which of the entity’s activities most significantly impacts the VIE’s economic performance and then identify the party that directs that activity. That party is deemed to have power and is therefore the VIE’s primary beneficiary assuming that it holds a variable interest that also meets the significant economic interest criterion in ASC subparagraph 810-10-25-38A(b). A thorough understanding of the VIE’s purpose and design and any other relevant facts and circumstances will be helpful to reporting enterprises when making this determination. In a speech at the 2014 AICPA National Conference on Current SEC and PCAOB Developments, a member of the SEC staff commented on the staff’s views about shared power analyses. An excerpt from the speech follows:

Excerpt from Speech by Christopher F. Rogers

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 parties2. 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 exists3. 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 power4. 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.

2 The significant activities of a VIE are the activities that most significantly impact the VIE’s economic performance.

3 ASC 810-10-25-38D provides that “[P]ower is shared if two or more unrelated parties together have the power to direct the activities of the VIE that most significantly impact the VIE’s economic performance and if decisions about those activities require the consent of each of the parties sharing power.”

4 Paragraphs A55 of the Basis for Conclusions to FASB Statement No.167, Amendments to FASB Interpretation No. 46(R), states, in part: “To the Board, it was important that decisions require the consent of each party sharing power because this would be most indicative of a group of parties that had agreed to share the power to direct the activities of a variable interest entity. The Board believes that situations in which decisions can be made without the consent of each party directing certain activities of the entity simply indicate that different parties have power over different activities, but those situations do not represent shared power over the entity.”

5 Paragraph A56 of the Basis for Conclusions to Statement 167 states, in part: “The Board acknowledged that situations could exist in practice in which multiple parties are directing the activities that significantly impact the economic performance of the entity, but those parties do not need to consent to the decisions relating to those activities. The Board noted that such situations would not meet the definition of shared power... In the Board’s view, if those parties are directing different activities, then the consolidation principle in [the VIE subsection of Topic 810] requires those parties to decide if they have power to direct the activities that have the most significant impact on the economic performance of the entity (that is, the application of the principle... would result in one of those parties having the [power characteristic]).”

6 The Staff believes this is directionally consistent with the principle articulated in Case H4 in ASC 810-10-55-197 and 55-198 and in paragraph A57 of the Basis for Conclusions to Statement 167 which states, in part: “The Board also observed that, in practice, there could be situations in which the parties involved with an entity have power over different activities and
portions of the same activities. The Board reasoned that, in those situations, an enterprise’s power over certain activities, along with its power over portions of other activities, might identify that enterprise as the party with the power to direct activities that most significantly impact the economic performance of the entity.

6.2.80. Specific Arrangements – Analyzing the Power Criterion

Question 6.2.80.1: Power Analysis for Single Lessee Leasing Arrangements

Should a lessee in a single-lessee leasing arrangement be deemed to have the power to direct the activities that most significantly impact the lessor entity’s economic performance?

Interpretive Response: In some situations. Case G at ASC paragraphs 810-10-55-172 through 55-181 addresses a single-lessee leasing arrangement in the context of a synthetic lease and indicates that the lessee would be considered the primary beneficiary of the lessor entity. In explaining that conclusion, ASC paragraph 810-10-55-178 states in part:

The economic performance of the VIE is significantly impacted by the fair value of the underlying property and the credit of the lessee. The lessee’s maintenance and operation of the leased property has a direct effect on the fair value of the underlying property, and the lessee directs the remarketing of the property. The lessee also has the ability to increase the benefits it can receive and limit the losses it can suffer by the manner in which it uses the property and how it remarkets the property.

The analysis of Case G implies that the economic utility of the leased asset enjoyed by the lessee during the lease term affects the evaluation of the ASC subparagraph 810-10-25-38A(a) power criterion. That economic utility becomes part of the lessor entity’s economic performance with the lessee being viewed as the party with the power to direct the activities pertaining to that portion of the lessor entity’s economic performance. The effect of the leased asset’s utility during the lease term on the lessor entity’s economic performance must be weighed against the other factors that impact the lessor entity’s economic performance (i.e., the economic utility of the leased asset and the changes in its fair value after the end of the lease term) in determining which party has the power to make decisions that most significantly impact the lessor entity’s economic performance.

This approach is consistent with the guidance in Case G at ASC paragraphs 810-10-55-78 through 55-80, which requires the design of the entity, rather than the U.S. GAAP characterization of the arrangement, to be the basis for determining whether the lessee has a variable interest in the lessor. However, this approach would not always result in the lessee being deemed the primary beneficiary of the lessor in a single-lessee leasing arrangement. For example,
if the lessee does not have a variable interest in the lessor under ASC paragraph 810-10-55-39, the lessee is not eligible to be the primary beneficiary of the lessor entity. In addition, even if the lessee has a variable interest in the lessor entity, the lessee would need to be able to exercise power with respect to a majority of the lessor entity’s economic performance to have the power to make the decisions that most significantly impact the entity’s economic performance and be the primary beneficiary of the entity. While the lessee would clearly have that power in a synthetic lease, it would not necessarily be true in all single-lessee leasing arrangements. Generally, we believe a lessee in a single-lessee leasing arrangement that takes on a majority of the risk of the leased asset over its remaining economic life (as evidenced through the sum of the present value of the minimum lease payments, including residual value guarantees, plus the fair value of the contingent rents and fixed-price purchase and renewal options in relation to the fair value of the leased asset) would meet the ASC subparagraph 810-10-25-38A(a) power criterion and would be the primary beneficiary of the lessor entity in which it holds a variable interest until the lessee ceases to be exposed to a majority of the risk of the leased asset over its remaining economic life, which may occur before the lease arrangement terminates or is modified.

We believe that other offtake arrangements, such as power purchase and capacity purchase arrangements, should be evaluated similarly. In those arrangements, the purchaser (offtaker) should determine whether it has a variable interest in the seller (provider of power/capacity), which may be affected by whether the arrangement contains a lease. If the purchaser has a variable interest in the seller, that will likely cause the seller to be a VIE because the seller’s equity investors will likely lack one or more of the characteristics in ASC subparagraph 810-10-15-14(b). If the purchaser has a variable interest in the seller and the seller is a VIE, the purchaser must evaluate whether it has the power to make the decisions that most significantly impact the seller’s economic performance, which will depend in part on the nature of the seller’s assets and operations. For example, the decisions that most significantly impact the economic performance of an entity that owns and operates a coal-fired power plant likely will differ from the decisions that most significantly impact the economic performance of an entity that owns and operates a wind farm. An offtaker’s involvement in the design of entities that own and operate renewable energy technologies may be an important factor to consider in evaluating whether the offtaker has the power to direct the activities that most significantly impact their economic performance. Also see Question 6.2.20.1. A purchaser that takes on a majority of the risk of the seller’s assets over their remaining economic life through an offtake arrangement may have the power to direct the activities that most significantly impact the seller’s economic performance and, if it has that power, would be the primary beneficiary of the seller in which it holds a variable interest likely until the purchaser ceases to be exposed to a majority of the risk of the seller’s assets over their remaining economic life, which may occur before the offtake arrangement terminates or is modified.
Question 6.2.80.2: Evaluating Power in Trust-Preferred Securities Arrangements

In a trust preferred securities arrangement, which party, if any, would have the power to direct the activities that most significantly impact the Trust’s economic performance?

Background

A trust-preferred securities arrangement generally involves the establishment by an enterprise, such as a bank, of a limited-purpose trust (Trust) to issue the trust-preferred securities. The Trust issues preferred securities to outside investors and uses the proceeds of the issuance to purchase from the enterprise an equivalent amount of junior subordinated debentures or other loans having stated maturities. The debentures or other loans are the only assets of the Trust. When the enterprise pays interest on the debentures or other loans, the Trust distributes the cash to the holders of the trust-preferred securities. The trust-preferred securities must be redeemed on maturity of the debentures or other loans. In some structures, the Trust writes a fixed-price call option to the enterprise that is embedded in the obligation of the enterprise to the Trust. This call option permits the enterprise to call the loan, for example at par. The option generally is exercisable beginning sometime after the issuance of the trust-preferred securities. The sponsoring enterprise typically holds all of the common equity of the Trust.

Interpretive Response: The sponsoring enterprise typically would have the power to direct the activities that most significantly impact the Trust’s economic performance in a trust-preferred securities arrangement. If so, and if the sponsoring enterprise does not have a variable interest in the Trust, the Trust would not have a primary beneficiary. This result is consistent with the previous application of the VIE subsections of ASC Subtopic 810-10 (before the ASU 2009-17 amendments) to trust-preferred securities arrangements. The following example illustrates these points.

Bank S decides to issue trust preferred securities. To facilitate the issuance of these securities, Bank S forms a limited-purpose trust (Trust P). Bank S purchases all of Trust P’s common securities, which represents 3% of the overall capital of Trust P. Trust P issues preferred securities to investors and uses the proceeds to purchase an equivalent amount of junior subordinated debentures or other loans (with terms identical to those of the trust preferred securities) from Bank S. The debentures or other loans are the only assets of Trust P.

When Bank S pays interest on the debentures or other loans, Trust P distributes the cash to the holders of the trust-preferred securities. The trust-preferred securities must be redeemed on maturity of the Bank S loan.
Trust P writes a fixed-price call option to Bank S that is embedded in the obligation of Bank S to Trust P. The call option allows Bank S to call the loans at par at any time beginning five years after issuance of the trust preferred securities.

The purpose of Trust P is to provide investors with the ability to invest in junior subordinated debentures of Bank S and provide Bank S with necessary financing. The principal risks to which Trust P is exposed include credit risk of its underlying assets (essentially credit risk of Bank S) and prepayment risk.

The economic performance of Trust P is most significantly impacted by the performance of its underlying assets. Because the activities of Trust P are generally restrictive and are predetermined, Bank S was significantly involved in the design of Trust P, and Bank S is the only entity that can significantly impact the performance of the underlying assets of Trust P (through exercise of the call option), Bank S is the party with the power to direct the activities that most significantly impact Trust P’s economic performance. Therefore, Bank S would meet the condition in ASC subparagraph 810-10-25-38A(a).

However, for Bank S to be Trust P’s primary beneficiary, Bank S would also need to be obligated to absorb losses or have the right to receive benefits that could potentially be significant to Trust P. Bank S’s common stock investment in Trust P is not a variable interest because it absorbs a risk created by its holder. Additionally, the provisions of ASC paragraph 810-10-55-31 require Bank S to ignore the embedded call option when identifying variable interests. Therefore, Bank S would not meet the condition in ASC subparagraph 810-10-25-38A(b).

Because no enterprise meets both of the conditions of a controlling financial interest, Trust P will not be consolidated under ASC Subtopic 810-10.

**Question 6.2.80.3: Evaluating Power When the Decision-Maker’s Fee Is Not a Variable Interest**

If a VIE has only one variable interest holder other than a decision maker whose fee is not a variable interest, would that variable interest holder always have the power to direct the activities that most significantly impact the VIE’s economic performance?

**Background**

Assume a general partner holds a 2% equity interest in a limited partnership that is a VIE, and its decision maker fee is embedded in its equity interest. The general partner's fee does not represent a variable interest (i.e., the conditions in ASC paragraph 810-10-55-37 have been met; see Section 3.5, *Fees Paid to Decision Makers or Service Providers*, for additional discussion). One limited partner holds a 98% limited partnership interest. That limited partner lacks...
substantive participating rights or kick-out rights. The general partner and limited partner are not related parties and neither holds an interest in the other.

**Interpretive Response:**

**Not necessarily.** Generally, a limited partner should not consolidate a limited partnership that is a VIE if it does not meet the power criterion in ASC subparagraph 810-10-25-38A(a) (unless it is required to do so under the related party primary beneficiary requirements, see Section 7, Related Parties and De Facto Agency Relationships, for additional discussion). In this situation, although the limited partner has an obligation to absorb losses or right to receive benefits from the limited partnership that could potentially be significant, the limited partner lacks the power to direct the activities that most significantly impact the limited partnership’s economic performance.

However, as discussed in Question 6.3.30.4, *Applicability of Primary Beneficiary Evaluation for a Decision Maker Whose Fee Is Not a Variable Interest*, the limited partner also should evaluate whether it is acting as a principal with power over the limited partnership. When a decision maker fee is not a variable interest, it may be necessary to evaluate whether the decision maker's stated or contractual decision-making rights substantively are attributable to another variable interest holder (i.e., the limited partner). In a speech at the 2014 AICPA National Conference on Current SEC and PCAOB Developments, a member of the SEC staff commented on these situations. The staff noted "...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, the 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."

See Question 6.1.20.2: *Decision-Making Rights Conveyed through a Non-Variable-Interest Decision Maker Fee*, for the general partner’s consolidation analysis and Example 7.3.10.1, *Determining the Primary Beneficiary in a Common Control Group When the Single Decision Maker’s Fee Is Not a Variable Interest*, for additional discussion of this fact pattern when the general partner and the limited partner are related parties under common control.

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**Question 6.2.80.4: Evaluating the Primary Beneficiary for GNMA Pools**

In a securitization of Government National Mortgage Administration (Ginnie Mae, or GNMA) loans, which party is the primary beneficiary?

**Background**

*NOTE: This guidance is based on dialogue with the SEC staff in connection with a letter submitted by the Mortgage Bankers Association of America (MBA). As part of the conclusion of this pre-clearance, the MBA submitted a*
confirmation letter dated February 10, 2010 to the SEC staff summarizing the SEC staff’s conclusion. In the confirmation letter, MBA clarified its understanding that the conclusions apply only to GNMA I and GNMA II pools and should not be analogized to other situations.

GNMA is a wholly-owned corporate instrumentality of the United States within the Department of Housing and Urban Development. GNMA guarantees the timely payment of principal and interest on securities that are backed by pools of federally-insured or guaranteed mortgages, primarily loans insured by the Federal Housing Administration (FHA) or guaranteed by the Department of Veterans Affairs (VA).

GNMA securitizations are unique from typical MBS vehicles in that there is no trust holding the mortgages backing the GNMA pass-through certificates. Rather, the GNMA MBS programs call for establishing custodial pools (i.e., GNMA I and II pools), whereby the issuer/servicer conveys to GNMA all rights, title, and interest to mortgages in the pool. GNMA does not purchase mortgage loans nor issue securities. Issuers, which are private lending institutions approved by GNMA, originate eligible government loans, pool them into securities, and issue GNMA MBS.

GNMA MBS are created when eligible mortgage loans (those insured or guaranteed by FHA, VA, RHS, or PIH) are pooled by approved issuers and securitized under guidelines issued by GNMA. GNMA MBS investors receive a pro rata share of the resulting cash flows (net of servicing and guarantee fees). GNMA itself does not issue securities, but instead guarantees the GNMA MBS issued by banks, thrifts, and mortgage bankers that participate in GNMA’s programs.

While a trust does not issue beneficial interests and hold the securitized assets like a typical securitization vehicle, we believe that GNMA I and GNMA II pools are legal structures created by legislation to “conduct activities and hold assets” and therefore meet the ASC Master Glossary definition of a legal entity. Further, we believe that the pools are within the scope of ASC Topic 810. That is, we do not believe the scope exception in ASC paragraph 810-10-15-12 (which states that a reporting entity should not consolidate a governmental organization) applies to the GNMA MBS program. These conclusions were subject to consultation with the SEC staff and it did not object to them.

Because GNMA I and GMNA II pools are static vehicles that require all cash flows to be paid to the beneficial interest holders as principal and interest (i.e., the beneficial interests in the pools would be reported as debt on each pool’s balance sheet), they have no equity investment at risk and are considered variable interest entities.

**Interpretive Response**

The primary purpose of these entities is to provide investors with the opportunity to invest in credit-protected mortgages and to provide cost-effective
secondary market liquidity for FHA and VA loans. This mechanism provides issuers the ability to originate additional loans to low/moderate income households and veterans. The design of the entity also provides a servicing fee for the issuer/servicer. However, the servicing fees are not a primary purpose of the entities because the issuer/servicer is entitled to those benefits before the transfer.

The MBS transactions are marketed to potential investors as an investment in a portfolio of residential mortgage loans with exposure to the credit risk of FHA/VA, the issuer, and GNMA, and prepayment risks associated with the underlying mortgage loans.

The parties involved with the VIE, and their respective variable interests, are as follows:

- The MBS investor absorbs substantially all prepayment risk and the minor risk of guarantor default.
- FHA, VA, and GNMA's potential variable interest is its guarantee of the principal and interest of the GNMA MBS.
- The issuer/servicer typically has multiple involvements in a GNMA issuance that may represent variable interests. First, the issuer may be an investor in the MBS, which subjects it to the risks noted above. Second, as servicer, the servicing fee may be a variable interest. The issuer/servicer also commonly has an option to repurchase defaulted receivables from the GNMA pools, and an obligation for standard representations and warranties.

The activities that most significantly impact the entities’ economic performance are management of credit risk, and to a lesser extent, prepayment risk. The MBS investors have no power to direct the activities that impact credit or prepayment risk. The insuring/guaranteeing agencies (e.g., FHA, VA, and GNMA) set the guidelines for servicing, including forbearance, foreclosure, and collection processes, and can change these guidelines as they see fit. In addition, ASC paragraph 810-10-25-38F indicates that if a sponsor has an explicit or implicit financial responsibility to ensure that the VIE is operated as designed, the sponsor may have established arrangements that make it the entity with the power over the activities that most significantly impact the VIE's economic performance. Finally, the issuer/servicer must service delinquent mortgages and manage foreclosure, collection, and assignment procedures under the requirements of the governmental agencies (FHA, VA, GNMA). The servicers' discretion is limited to discretion permitted by the Guides of GNMA and the insuring/guaranteeing agencies, which can change at the discretion of those agencies.

Because multiple parties are involved in the activities that most significantly impact the entities' economic performance (management of credit risk), ASC paragraph 810-10-25-38E requires a determination of which of these parties' activities most significantly impact the entities' financial performance, and only
one party can be determined to have this power. For this determination, the various governmental organizations and GNMA are analyzed together because they are considered to be related due to their governmental nature.

The governmental entities control the design of the VIE, and dictate the quality and the nature of the collateral, require the underlying insurance, and set the prescriptive servicing guides that the issuer/servicer must apply (and can also change those guides at will). The issuer/servicer's power relates to selecting the specific loans for each pool, making decisions within the narrow parameters of the servicing guides, and deciding whether to exercise the call option for defaulted mortgages.

When consulted, the SEC staff did not object to the conclusion that the issuer/servicer is not the primary beneficiary of these entities based on the fact that the governmental entities' control over the prescriptive servicing guidelines gives them power over the management of those activities that most significantly impact the entities' economic performance.

6.3. OBLIGATION TO ABSORB LOSSES OR RIGHT TO RECEIVE BENEFITS

6.3.10. Overview

6.3.10.10. Aside from having power, an enterprise must also have the obligation to absorb losses or receive benefits that could potentially be significant to a VIE to be the primary beneficiary of the VIE. Reporting enterprises should consider both current and potential future circumstances when evaluating this criterion. The FASB decided not to provide additional guidance on whether an enterprise’s obligation to absorb losses or its right to receive benefits could potentially be significant to the VIE, as it believed that this would create *bright lines* that would be used as rules in practice. The Board instead emphasized that all facts and circumstances, including the VIE’s purpose, design, and characteristics, and the enterprise’s other involvements with the VIE should be considered. Factors that may be evaluated when determining whether an enterprise’s obligation to absorb losses or receive benefits could potentially be significant to the VIE include:

- The purpose, design, and structure of the VIE, including the terms of the VIE’s variable interests and nature of its variability;
- Whether any of the enterprise’s or VIE’s exposure to losses or benefits is capped;
- The nature of the VIE’s capital structure, including where in the structure the enterprise’s interest resides;
- The magnitude of the VIE’s variable interests held by the reporting enterprise; and
- The rationale for the enterprise holding a variable interest in the VIE. For example, holding an interest for reputational reasons may indicate...
that the reporting enterprise is exposed to losses or benefits that may be significant to the VIE.

**Question 6.3.10.1: Meaning of Losses of, and Benefits from, the Entity**

When evaluating whether an enterprise’s variable interest obligates it to absorb losses or entitles it to receive benefits that could potentially be significant to the VIE, what is meant by *losses of the entity* and *benefits from the entity*?

Interpretive Response: We believe that the terms *losses of the entity* and *benefits from the entity* are not limited only to U.S. GAAP profits or losses. This concept is illustrated in Case G at ASC paragraphs 810-10-55-172 through 55-181, which implies that the economic utility of a leased asset enjoyed by the lessee during the lease term should be considered in the analysis of which party has the power to direct the activities that most significantly impact the economic performance of the lessor entity, even though the lessor entity does not recognize U.S. GAAP profits or losses from the performance of the leased asset during the lease term. Thus, even though the lessee is not entitled to any of the lessor’s GAAP income from the lease, the lessee’s variable interest is still viewed as conveying benefits from the lessor. Similarly, if an enterprise receives advertising services from a VIE and reimburses the VIE for the cost of those services, we believe that this benefit should be considered as part of the ASC subparagraph 810-10-25-38A(b) evaluation even though the VIE derives no net income as a result of the arrangement.

6.3.10.20. In paragraph A43 of the Basis for Conclusions to Statement 167, the FASB observed that quantitative analyses are often less precise and effective in quantifying risks and rewards than a qualitative analysis. Accordingly, the Board concluded that a quantitative evaluation of expected losses and residual returns is not required when evaluating whether a variable interest holder is obligated to absorb losses or entitled to receive benefits that could potentially be significant to a VIE. In a speech at the 2010 AICPA National Conference on Current SEC and PCAOB Developments, a member of the SEC staff commented on the staff’s views about exclusive reliance on quantitative analyses to evaluate the criterion in ASC subparagraph 810-10-25-38A(b). An excerpt from the speech follows:

**Excerpt from Speech by Paul A. Beswick**

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...

**Question 6.3.10.2: Qualitative Factors Alone Cannot Overcome Quantitative Evidence**

Can a reporting enterprise rely on a qualitative-based analysis to conclude that a quantitatively significant variable interest does not meet the criteria within ASC subparagraph 810-10-25-38A(b)?

**Interpretive Response:** No. We do not believe that a reporting enterprise could conclude that the criterion in ASC subparagraph 810-10-25-38A(b) is not met based exclusively on a qualitative analysis if the enterprise has a quantitatively significant variable interest or interests. Although a quantitative analysis is not required, readily apparent quantitative information cannot be ignored in a qualitative analysis. However, we believe that an enterprise may conclude that a quantitatively insignificant variable interest may potentially be significant based on qualitative factors, because future events or scenarios may arise that may cause its obligation to absorb losses or right to receive returns to increase.

**6.3.20. Potentially Significant Analysis**

**6.3.20.10.** As indicated in paragraph A41 of the Basis for Conclusions to Statement 167, the FASB decided not to change the guidance in ASC subparagraph 810-10-25-38A(b) to allow reporting enterprises to consider the likelihood that they would absorb losses or receive benefits that could potentially be significant to the VIE when performing their evaluation of the criterion in that paragraph. The Board reached the conclusion that all possibilities should be considered “because obligations or rights that could potentially be significant often identify the enterprise that explicitly or implicitly has the power to direct the activities that most significantly impact the economic performance of a variable interest entity.”

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10 Paragraph A39 of Statement 167.
Question 6.3.20.1: Effect of Power Conclusion on Potentially Significant Analysis

Do all variable interests that convey the power to direct the activities that most significantly impact a VIE’s economic performance also convey to their holder an obligation to absorb losses or a right to receive benefits that could potentially be significant to the VIE?

Interpretive Response: Presumptively yes. The FASB emphasized that “determining whether an enterprise has an obligation to absorb losses or right to receive benefits that could potentially be significant to a variable interest entity would require judgment and consideration of all facts and circumstances about the terms and characteristics of the variable interest(s), the design and characteristics of the variable interest entity, and the other involvements of the enterprise with the variable interest entity.”11 The FASB decided not to provide an analysis of how an enterprise should evaluate this guidance because it “would inevitably serve as the establishment of ‘bright lines’ that would be used in practice as the sole factor for determining whether such obligations or rights could potentially be significant to a variable interest entity.”12

In most situations, it is unlikely that a variable interest holder that has the power to direct the activities that most significantly impact an entity’s economic performance would not also have a variable interest that either conveys the obligation to absorb losses or the right to receive benefits that could potentially be significant to the VIE. We believe that this presumption is consistent with the Board’s sentiments expressed in ASC paragraph 810-10-25-38G that “the level of an enterprise’s economic interest may be indicative of the amount of power that enterprise holds,” and in paragraph A35 of Statement 167 that “the level of skepticism about an enterprise’s lack of power should increase as the disparity between an enterprise’s economic interest and its power increases.” That is, an enterprise typically would not be vested with the power to direct the activities that most significantly impact the economic performance of a VIE without also having more than an insignificant economic interest in the VIE.

However, it is possible for an enterprise with an insignificant economic interest in a VIE to have the power to direct the activities that most significantly impact the VIE’s economic performance via an agency relationship with other variable interest holders of the VIE, but only when specific prescriptive criteria are met. See discussion of Fees Paid to Decision Makers and Service Providers in Subsection 3.5, Variable Interests, for additional information about how to evaluate whether a decision maker functions as an agent of a VIE’s other variable interest holders. See also paragraph 6.3.30.10 for how to consider fees paid to a decision maker when evaluatingASC subparagraph 810-10-25-38A(b). This situation can also occur when a related party relationship exists among the variable interest holders. See discussion in Subsection 7.3, Effect

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12 Paragraph A41 of Statement 167.
Question 6.3.20.2: SEC Staff Views about Potentially Significant Analysis

What factors should be considered when determining whether a variable interest could potentially be significant to a VIE?

Interpretive Response: In a speech at the 2009 AICPA National Conference on Current SEC and PCAOB Developments, a member of the SEC staff discussed factors that should be considered when determining whether a variable interest could potentially be significant to a VIE. Excerpts from the speech follow:

Excerpts from Speech by Arie S. Wilgenburg

ASU 2009-17] describes [a significant financial] interest as one that either obligates the reporting enterprise to absorb losses of the entity or provides a right to receive benefits from the entity that could potentially be significant. That description leaves us with an important judgment to make regarding what could potentially be significant.

Similar to how we have talked in the recent past about materiality assessments being based on the total mix of information, we believe that assessing significance should also be based on both quantitative and qualitative factors. While not all-inclusive, some of the qualitative factors that you might consider when determining whether a reporting enterprise has a controlling financial interest include:

1. The purpose and design of the entity. What risks was the entity designed to create and pass on to its variable interest holders?

2. 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.

3. 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.

6.3.20.20. Consistent with the SEC staff speech, we believe that determining whether a variable interest could potentially be significant will require professional judgment and consideration of all facts and circumstances, including the purpose and design of the entity and the terms and characteristics of the enterprise’s variable interest. The ASC subparagraph 810-10-25-38A(b) significance analysis is not probability-based. As a result, we believe that the staff’s reference to seniority is directed at the need to understand, based on the characteristics of the financial instrument, what losses of the entity the interest could be obligated to absorb and what benefits from the entity the interest could be entitled to receive.

6.3.20.30. Additionally, we understand that the SEC staff intended the third factor related to the enterprise’s business purpose for holding the financial interest to be considered in the context of the ASC subparagraph 810-10-55-37(c) analysis of significance rather than the ASC subparagraph 810-10-25-38A(b) analysis of significance; that is, it might be a factor to consider when the power to direct the activities that most significantly impact the economic performance of the VIE is conveyed through a service contract, rather than through a non-fee variable interest. In that situation, the business circumstances that led to the enterprise holding the financial interest may be relevant in evaluating whether the enterprise is acting solely as a fiduciary under the provisions of ASC paragraph 810-10-55-37. However, we believe that this factor typically would have little effect on the ASC paragraph 810-10-55-37 conclusion about whether a decision-maker fee is a variable interest. Further, we believe that the enterprise’s business purpose for holding the financial interest should not affect the ASC subparagraph 810-10-25-38A(b) evaluation of significance.

Question 6.3.20.3: Potentially Significant Analysis for Variable Interests That Absorb Insignificant Variability

Could a variable interest that is exposed to insignificant variability of a VIE nevertheless convey the obligation to absorb losses or the right to receive benefits that could potentially be significant to the VIE?

Interpretive Response: Yes. An enterprise must consider all possible scenarios (regardless of probability of occurrence) when evaluating whether its variable interest conveys the obligation to absorb losses or the right to receive benefits that could potentially be significant to the VIE. If, under any circumstances, it is possible that a variable interest would absorb losses or receive benefits that could be significant to the VIE (relative to total losses or total benefits in that given scenario) it would meet the characteristic in ASC
subparagraph 810-10-25-38A(b). An enterprise’s expectations of variability relative to a particular interest are not relevant to the analysis of the characteristic in ASC subparagraph 810-10-25-38A(b). The FASB reached the conclusion that all possibilities should be considered “because obligations or rights that could potentially be significant often identify the enterprise that explicitly or implicitly has the power to direct the activities that most significantly impact the economic performance of a variable interest entity.” The following example illustrates this concept.

Entity XYZ is created and financed with the issuance of two tranches (senior and mezzanine) of 30-year fixed-rate debt securities and the issuance of an equity tranche for total capital of $10 million. The equity tranche represents 5% of the total capital. Entity XYZ uses the proceeds to purchase $10 million of 30-year fixed-rate residential mortgage loans from Broker H and enters into a guarantee facility with Bank J under which Bank J is obligated to make payments only after the credit losses on Entity XYZ’s assets (30-year fixed-rate residential mortgage loans) exceed the amount of its equity tranche.

ASC subparagraph 810-10-25-38A(b) is intended to require variable interest holders to evaluate all potential scenarios that may occur during their involvement with a VIE, and determine whether their variable interest would be obligated to absorb losses or receive benefits that could potentially be significant to the VIE. The amount of losses that would be absorbed by Bank J if the guarantee is ever triggered could potentially be significant to Entity XYZ because the equity tranche represents only 5% of the total capital of Entity XYZ. Accordingly, even if it is unlikely that Bank J would be obligated to make payments under the guarantee arrangement, Bank J would meet the condition in ASC subparagraph 810-10-25-38A(b).

A residual interest, or other interest with an equity-like return, presumptively would be potentially significant as it conveys the right to receive benefits that could be significant to the entity. Although a senior interest in a VIE with a debt-like return may lack the right to receive benefits that could be significant to the VIE, if the senior interest was significant relative to the VIE it would have the obligation to absorb losses that could be significant to the VIE. In contrast, when evaluating whether a fee is a variable interest under ASC paragraph 810-10-55-37(c), an enterprise would consider the probability of occurrence of events in determining whether its other interests in the entity would absorb more than an insignificant amount of the VIE’s expected losses or expected residual returns.

6.3.30. Fees Paid to a Decision Maker or Service Provider

6.3.30.10. When a decision maker’s fees represent a variable interest in a VIE (as described in Subsection 3.5), the decision maker must determine whether it is the VIE’s primary beneficiary. The FASB decided in ASU 2015-02 to exclude

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13 Paragraph A39 of Statement 167.
fees paid to a decision maker or service provider from the potentially significant variable interest determination if:

- The compensation is commensurate with the services provided; and
- The arrangement includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated on an arm’s-length basis.

6.3.30.20. When fees are eligible for the evaluation and the conditions above are met, the fees are excluded from the potentially significant variable interest determination in the primary beneficiary evaluation irrespective of whether they are subject to lock-up provisions, settled in variable interests (i.e., not cash) of the VIE, or other variable interests are held by the decision maker or service provider. The revised consolidation guidance places more emphasis on variable interests other than fee arrangements because the FASB believes that these fee arrangements do not subject the decision maker to a risk of loss, unlike capital investments or guarantees. The risk associated with compensation that meets the two conditions above exposes a decision maker only to opportunity costs of the nonreceipt of fees and not exposure to losses and, therefore, reflects an agency or fiduciary role.14

6.3.30.30. Fees or payments in arrangements that expose the decision maker or service provider to risk of loss in the VIE (e.g., guarantees of the value of the assets or liabilities of a VIE, fees in relation to obligations to fund operating losses, etc.), including those for decision-making services, are not eligible for the above exclusion and therefore are included in evaluating whether a decision maker has a potentially significant variable interest. This serves as an override to ensure that if an arrangement is structured as a means to absorb risk of loss through an actual fee arrangement, the arrangement will be included in the evaluation in ASC subparagraph 810-10-25-38A(b).15

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<tr>
<th>Question 6.3.30.1: Fees Included in Evaluating the Potentially Significant Variable Interest Primary Beneficiary Criterion</th>
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<td>What fees should be included by the decision maker in evaluating whether it has the obligation to absorb losses that could potentially be significant to the VIE and/or right to receive benefits that could potentially be significant to the VIE (ASC subparagraph 810-10-25-38A(b))?</td>
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**Interpretive Response:** The FASB decided in ASU 2015-02 that fees or payments in connection with arrangements that expose the decision maker to risk of loss in the VIE (e.g., guarantees of the value of the assets or liabilities of the VIE, obligations to fund operating losses, etc.), including those for decision-making services, should be included in the evaluation of the potentially significant variable interest primary beneficiary criterion. The FASB wanted to ensure that if an arrangement is structured as a means to absorb risk of loss in

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14 Paragraph BC42 of ASU 2015-02.
15 Paragraph BC43 of ASU 2015-02.
exchange for a fee, that the arrangement will be included in the evaluation of
ASC subparagraph 810-10-25-38A(b).

However, we do not believe the requirement to automatically consider fees or
payments in connection with agreements that expose the decision maker or
service provider to risk of loss in the VIE to be variable interests is likely to
matter very much. If the decision maker or service provider meets the criteria
to be the primary beneficiary of a VIE on the basis of its decision-making rights
and the risks to which it is exposed through its variable interests, we believe
considering the fees a variable interest is unlikely to change that conclusion.
Likewise, if the decision maker or service provider does not meet the criteria to
be the primary beneficiary of a VIE on the basis of its decision-making rights
and the risks to which it is exposed through its variable interests, considering
the fees a variable interest will not change that conclusion unless those fees
provide the right to receive benefits that could potentially be significant to the
VIE.

Question 6.3.30.2: Threshold for Potentially Significant Variable Interest
and More Than Insignificant Expected Losses and Expected Residual
Returns

Is the threshold for evaluating whether a reporting enterprise has the obligation
to absorb losses or right to receive benefits that could potentially be significant
to a VIE (ASC subparagraph 810-10-25-38A(b)) the same as the threshold for
evaluating whether a decision maker or service provider holds other interests
that would absorb (receive) more than an insignificant amount of a VIE’s
expected losses (expected residual returns) (ASC subparagraph 810-10-55-
37(c))?

Interpretive Response: ASC Subtopic 810-10 provides no quantitative
threshold for determining what could potentially be significant in the primary
beneficiary evaluation and what is insignificant in the evaluation of whether
fees paid to a decision maker or servicer provider is a variable interest. While
the notions of could potentially be significant and insignificant operate
differently, the threshold of significance for each is the same. We believe it may
be reasonable to presume the conditions are met using a threshold of 10%.
That is, a decision maker or service provider fee would not be a variable
interest under ASC subparagraph 810-10-35-55(c) if other interests do not
absorb more than 10% of the VIE’s total expected variability. Additionally, a
reporting enterprise would not have a potentially significant variable interest
and would not individually meet the primary beneficiary criteria if it did not have
an interest that could potentially absorb more than 10% of an entity’s losses or
could potentially receive more than 10% of the entity’s benefits.

For purposes of ASC subparagraph 810-10-55-37(c), an enterprise should
consider the VIE’s expected (probability-weighted) outcomes when assessing
the significance of other interests. However, the evaluation of whether an
Question 6.3.30.3: Evaluating ASC Subparagraph 810-10-25-38A(b) When a Fee Is a Variable Interest

Could a decision maker or service provider fee that is determined to be a variable interest under ASC subparagraphs 810-10-55-37(a) or 55-37(d) be determined not to convey to its holder an obligation to absorb losses or a right to receive benefits that could potentially be significant to the VIE under ASC subparagraph 810-10-25-38A(b)?

Interpretive Response: Generally, no. We believe that if a decision maker or service provider fee does not meet the conditions in ASC subparagraphs 810-10-55-37(a) or 55-37(d) (i.e., the fee is considered a variable interest), it usually conveys to the holder the obligation to absorb losses or right to receive benefits that could potentially be significant to the VIE (i.e., it meets the condition in ASC subparagraph 810-10-25-38A(b)). As a result, if a fee is determined to be a variable interest under ASC subparagraphs 810-10-55-37(a) or 55-37(d), the decision maker or service provider usually would meet both of the conditions of a controlling financial interest in ASC paragraph 810-10-25-38A and would be determined to be the primary beneficiary. An example of an exception to the general circumstance is where the decision maker does not receive a fee for its services. In those instances, the fee would be a variable interest but would not necessarily meet the condition in ASC subparagraph 810-10-25-38A(b).

Question 6.3.30.4: Applicability of Primary Beneficiary Evaluation for a Decision Maker Whose Fee Is Not a Variable Interest

Can a decision maker be the primary beneficiary of a VIE if its fee does not represent a variable interest?

Interpretive Response: No. Paragraph BC76 of ASU 2015-02 indicates that once a decision maker determines that its fee meets the conditions in ASC paragraphs 810-10-55-37 and 55-38 (i.e., to not be a variable interest), the decision maker would not need to continue with its VIE consolidation analysis. See Example 6.3.30.1 below.

In paragraph A42 of Statement 167, the FASB “observed that if an enterprise concludes that its involvement in a variable interest entity does not represent a variable interest, further analysis of whether the enterprise’s obligation to absorb losses or its right to receive benefits could potentially be significant would not be required because a party cannot be the primary beneficiary of an entity if that party does not hold a variable interest in the entity.”
A76 of Statement 167, the FASB stated that it “expects that the fees paid to an enterprise that acts solely as a fiduciary or agent should typically not represent a variable interest in a variable interest entity because those fees would typically meet the conditions in [ASC paragraph 810-10-55-37]”. Finally, the guidance in ASC subparagraph 810-10-15-14(b)(1) states that a decision maker does not preclude the equity-at-risk investors from having the power, through voting rights or similar rights, to direct the activities that most significantly impact an entity’s economic performance if the fees paid to the decision maker do not represent a variable interest under the provisions of ASC paragraphs 810-10-55-37 and 55-38.

See Question 6.2.80.3: Evaluating Power When the Decision-Maker’s Fee Is Not a Variable Interest, and Question 6.1.20.2: Decision-Making Rights Conveyed through a Non-Variable-Interest Decision Maker Fee, for examples of the consolidation analysis when the general partner does not have a variable interest and there is only one unrelated limited partner. In addition, Example 7.3.10.1, Determining the Primary Beneficiary in a Common Control Group When the Single Decision Maker’s Fee Is Not a Variable Interest, provides additional discussion of this same fact pattern when the general partner and the limited partner are related parties under common control.

When a decision maker’s fee is not a variable interest, it may be necessary to evaluate whether the decision maker’s stated or contractual decision-making rights substantively belong to another variable interest holder. In a speech at the 2014 AICPA National Conference on Current SEC and PCAOB Developments, a member of the SEC staff commented on these situations. An excerpt from the speech follows:

**Excerpt from Speech by Christopher F. Rogers**

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.

7 Paragraph A76 of the Basis for Conclusions to Statement 167 provides that a decision maker is acting in an agency capacity when the fee it receives for performing services is not a variable interest.
8 ASC 810-10-55-37.
9 ASC 810-10-25-38G.

Example 6.3.30.1: Investment Manager Holds Seed Capital

At its inception, Entity A is the manager of an investment fund and receives a market-based fee that meets the conditions in ASC subparagraphs 810-10-55-37(a) and (d). Entity A also holds 100% of the seed capital of the fund. The design of the fund is to obtain third-party investors and reduce the investment manager’s equity interest to 5% over a three-year period. As investment manager, Entity A has the power to direct the activities that most significantly impact the economic performance of the fund. The fund is a VIE because its investors lack power through voting rights of equity-at-risk interests (substantive kick-out rights or substantive participating rights) to direct the activities that most significantly impact the fund’s economic performance.

Entity A’s fee would be a variable interest because its 100% equity interest absorbs more than an insignificant amount of the fund’s expected losses (it also receives more than an insignificant amount of the fund’s expected residual returns). Therefore the condition in ASC subparagraph 810-10-55-37(c) is not met. Entity A would be considered the fund’s primary beneficiary because it has (1) power to direct the activities that most significantly impact the fund’s economic performance and (2) the obligation to absorb losses (and right to receive benefits) that could potentially be significant to the fund.

Assume that three years after the fund’s inception, various third parties acquire 80% of the equity interests in the fund and a related party under common control with Entity A acquires 15% of the fund’s equity interests (Entity A does not hold an interest in the affiliate). At that point, whether Entity A’s fee is a variable interest depends on whether the investment by its affiliate is made to
separate power from economics so that Entity A can avoid consolidation of the fund in Entity A's stand-alone financial statements. If so, Entity A’s fee would still be a variable interest because its affiliate holds an interest that absorbs more than an insignificant amount of the fund’s expected losses or receives more than an insignificant amount of its expected residual returns (i.e., Entity A still would not meet the condition in ASC subparagraph 810-10-55-37(c)). If not, Entity A’s fee would not be considered a variable interest because the interest held by its affiliate would be excluded from the evaluation and Entity’s A’s direct and indirect interests do not absorb more than an insignificant amount of the fund’s expected losses or receive more than an insignificant amount of its expected residual returns.

If Entity A’s fee is considered a variable interest in the fund, it would be required to evaluate whether it meets both criteria to be the fund’s primary beneficiary. If it does not meet both criteria, it would be required to evaluate whether it is part of a group of related parties under common control that collectively meet the criteria to be the fund’s primary beneficiary (See Section 7). In this scenario, because Entity A only holds a 5% equity interest in the fund, it would not meet the potentially significant variable interest primary beneficiary criterion. However, if its fee is considered a variable interest, it would be part of a group of related parties under common control that collectively meet the criteria to be the fund’s primary beneficiary. Entity A would therefore be required to evaluate whether it is the primary beneficiary of the VIE on the basis of being the party that is most closely associated with the VIE (ASC paragraph 810-10-25-44).

However, if Entity A’s fee is not considered a variable interest, for reasons discussed further in Questions 6.3.30.4 and 7.3.10.1, Entity A would not be the VIE’s primary beneficiary.

See Question 3.5.20.1 for a discussion of guidance from the FASB staff that may have been applied by reporting enterprises that adopted ASU 2015-02 before its effective date to determine whether a decision maker’s fee is a variable interest. That guidance differs from the analysis above but should not be applied following the SEC staff speech discussed in Question 3.5.20.1.

**Question 6.3.30.5: Applicability of ASC Paragraph 810-10-25-38A When Power Is Conveyed Through a Non-Fee Variable Interest**

If an enterprise has decision-making rights conveyed through a non-fee variable interest, can that enterprise be the primary beneficiary of a VIE?

**Interpretive Response:** Yes. An enterprise that has decision-making rights conveyed through a variable interest other than a fee-based arrangement would be required to evaluate whether its variable interest causes it to be the VIE’s primary beneficiary under the provisions of ASC paragraph 810-10-25-38A. For example, in a lending arrangement, the lender may receive rights to make decisions about the activities that most significantly impact the...
borrower’s economic performance in an event of default. In that situation, the lender would be required to evaluate whether it is the borrower’s primary beneficiary under ASC paragraph 810-10-25-38A.

6.4. DISPROPORTIONALITY BETWEEN ECONOMIC INTEREST AND DECISION-MAKING RIGHTS

6.4.10.10. Generally speaking, the greater a reporting enterprise’s exposure to a VIE’s losses or benefits the more likely it is that the reporting enterprise will possess power to direct the activities that most significantly impact the VIE’s economic performance. However, there may be situations where a reporting enterprise is exposed to economic risks that are disproportionately less than the power it possesses. In situations where disproportionality exists, reporting enterprises should carefully evaluate whether (1) the activities that most significantly impact the VIE’s economic performance have been appropriately identified and (2) whether all arrangements or other interests that convey power have been appropriately analyzed. This evaluation should be documented by reporting enterprises along with significant judgments made.

Question 6.4.1: Relationship between VIE Determination under ASC Subparagraph 810-10-15-14(c) and the Primary Beneficiary Assessment

If an entity is deemed to be a VIE based on the guidance in ASC subparagraph 810-10-15-14(c), does this have any effect on the identification of the entity’s primary beneficiary?

Interpretive Response: Not necessarily. To prevent reporting enterprises from structuring entities in a manner that would allow them to avoid consolidation, ASC subparagraph 810-10-15-14(c) states that an entity is a VIE where (1) the voting rights of some investors are not proportional to their obligation to absorb the expected losses and their right to receive the expected residual returns of the entity, or both, and (2) substantially all of the entity’s activities either involve or are conducted on behalf of an investor that has disproportionately few voting rights. While we do not believe that the equity investors in entities that are VIEs under ASC subparagraph 810-10-15-14(c) necessarily have non-substantive voting rights, we believe this circumstance requires special care to ensure that the enterprise holding substantive power is properly identified. Reporting enterprises should critically evaluate all relevant facts and circumstances when determining which enterprise has power over the VIE, particularly those pertaining to substantive terms, transactions, and arrangements as contemplated in ASC paragraphs 810-10-15-13A and 15-13B.
Question 6.4.2: SEC Staff Views about Substance Considerations for Purposes of Evaluating Shared Power

What is the effect on a shared power analysis when the economic interests of the parties with shared power are disproportionate to their decision-making rights?

Interpretive Response: In a speech at the 2009 AICPA National Conference on Current SEC and PCAOB Developments, a member of the SEC staff indicated that all facts and circumstances should be considered in evaluating whether the terms of a shared power arrangement are substantive and that disproportionality between the decision-making rights and the economic interests of the parties with shared power may indicate that the parties’ stated rights are not substantive, particularly when one of the parties is exposed to substantially all of the risks of ownership. An excerpt from the speech follows:

Excerpt from Speech by Arie S. Wilgenburg

In the vein of encouraging the use of reasonable judgment, it is worth noting that only substantive terms should be considered when applying [the VIE guidance in ASC Subtopic 810-10]. Determining whether something is substantive or non-substantive is likewise a matter of judgment and depends on the facts and circumstances.

Keeping with the topic of considering the economic substance of a transaction, the staff has recently become aware of several proposed structures designed to achieve deconsolidation of underperforming assets, including past due loans, securities, and real estate. These assets are likely presenting business performance and prudential regulatory compliance issues. In order to address these issues, several structures have been proposed in which owners transfer the underperforming assets to a structure designed to technically comply with the consolidation literature and perhaps create the appearance of shared power among equity holders. However, the economic result leaves substantially all of the risks of ownership with the original owner rather than a more substantive sharing of the risks.

For example, assume a company has transferred assets to a structure to be managed by a third party, but the manager’s equity interest in the structure is minimal and appears to be guaranteed given the management fee structure. In addition, assume the manager can be removed by the reporting enterprise if the manager’s performance is unsatisfactory. The combination of the above factors indicates that the company may not have relinquished control; rather the manager may simply be acting as an agent on behalf of the reporting enterprise. We have also seen other, similar structures that include a buy-sell clause rather than a removal right, as a mechanism for dissolving the structure. However, if the manager does not have the financial ability to exercise its rights under the buy-sell provision, the substance of this provision may be a call option by the transferor. Again, this may be an
indication that the manager is simply acting as an agent on behalf of the
reporting enterprise.

In summary, and consistent with our report to Congress on off-balance sheet
arrangements, the staff continues to believe that use of transaction
structuring to achieve accounting and reporting goals that do not conform to
the economic substance of the arrangements reduces transparency in
financial reporting.¹

¹ Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of
2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and
Transparency of Filings by Issuers, June 2005

6.4.10.20. As noted by the SEC staff, there may be circumstances in which a
manager that purportedly has shared power is actually acting as an agent of
another party that purportedly has shared power. In addition, a managing
member of an entity for which power is purportedly shared may meet the
condition in ASC subparagraph 810-10-25-38A(a). See Questions 6.2.70.1 and
6.2.70.2 for additional guidance. Also note that the staff’s views about
purportedly shared power when a party is exposed to substantially all of the risks
of ownership is consistent with the guidance in Question 6.2.20.1.

6.5. FASB EXAMPLES OF PRIMARY BENEFICIARY EVALUATION

6.5.10.10. The FASB provided the following examples about how to determine
the primary beneficiary in ASU 2009-17 and ASU 2015-02 that address both (a)
how to evaluate which party, if any, has the power to direct the activities that
most significantly impact a VIE’s economic performance and (b) how to evaluate
whether a party that has the power to direct the activities that most significantly
impact a VIE’s economic performance is either obligated to absorb losses of the
VIE that could potentially be significant to the VIE or entitled to receive benefits
from the VIE that could potentially be significant to the VIE:

Excerpt from ASC Subtopic 810-10

Example 5: Identifying a Primary Beneficiary

55-93 The following cases are provided solely to illustrate the application of the
guidance in paragraphs 810-10-25-38A through 25-38J related to the
identification of a primary beneficiary:

(a) Commercial mortgage-backed securitization (Case A)
(b) Asset-backed collateralized debt obligation (Case B)
(c) Structured investment vehicle (Case C)
(d) Commercial paper conduit (Case D)
(e) Guaranteed mortgage-backed securitization (Case E)
(f) Residential mortgage-backed securitization (Case F)

(g) Property lease entity (Case G)

(h) Collaboration--Joint venture arrangement (Case H)

(i) Furniture manufacturing entity (Case I)

(j) Investment fund 1—Annual and performance-based fees and additional interests (Case J)

(k) Investment fund 2—Annual and performance-based fees and no additional interests (Case K)

(l) eCommerce Entity (Case L).

55-94 The identification of a primary beneficiary, if any, in Cases A–L is based solely on the specific facts and circumstances presented. These Cases are hypothetical and are not meant to represent actual transactions in the marketplace. Although certain aspects of the Cases may be present in actual fact patterns, relevant facts and circumstances of a specific fact pattern or structure would need to be evaluated to reach an accounting conclusion. The Cases share the following assumptions:

(a) The legal entities in Cases A–I and Case L are presumed to be VIEs. These presumptions should be understood as fact and not as conclusions based on the other facts and circumstances in each case. Case J provides an explanation as to why the legal entity is a VIE. Case K does not indicate whether the legal entity is a VIE because the decision maker does not have a variable interest in the legal entity.

(b) All variable interests are presumed to be variable interests in the VIE as a whole, rather than variable interests in specified assets of the VIE, on the basis of the guidance in paragraphs 810-10-25-55 through 25-59.

55-95 In some Cases, certain fees are described as representing, or not representing, a variable interest on the basis of paragraphs 810-10-55-37 through 55-38. However, the Cases were not meant to illustrate the application of the guidance in those paragraphs, and additional facts would be necessary to determine which condition(s) resulted in the fee representing or not representing a variable interest. Specifically, certain Cases state whether certain fees are commensurate with the level of effort required to provide the related services and whether they are part of a service arrangement that includes only terms, conditions, or amounts that are customarily present in similar arrangements negotiated at arm’s length. Those presumptions should be understood as fact for purposes of reading each related Case and not as conclusions based on the other facts and circumstances described in each case. Finally, determining the primary beneficiary in accordance with the guidance in the Variable Interest Entities Subsections requires judgment and is
on the basis of individual facts and circumstances of the VIE and the reporting entity with the variable interest or interests.

Case A: Commercial Mortgage-Backed Securitization

55-96 A VIE is created and financed with $94 of investment grade 7-year fixed-rate bonds (issued in 3 tranches) and $6 of equity. All of the bonds are held by third-party investors. The equity is held by a third party, who is also the special servicer. The equity tranche was designed to absorb the first dollar risk of loss and to receive any residual return from the VIE. The VIE uses the proceeds to purchase $100 of BB-rated fixed-rate commercial mortgage loans with contractual maturities of 7 years from a transferor. The commercial mortgage loans contain provisions that require each borrower to pay the full scheduled interest and principal if the loan is extinguished prior to maturity. The transaction was marketed to potential bondholders as an investment in a portfolio of commercial mortgage loans with exposure to the credit risk associated with the possible default by the borrowers.

55-97 Each month, interest received from all of the pooled loans is paid to the investors in the fixed-rate bonds, in order of seniority, until all accrued interest on those bonds is paid. The same distribution occurs when principal payments are received.

55-98 If there is a shortfall in contractual payments from the borrowers or if the loan collateral is liquidated and does not generate sufficient proceeds to meet payments on all bond classes, the equity tranche and then the most subordinate bond class will incur losses, with further losses impacting more senior bond classes in reverse order of priority.

55-99 The transferor retains the primary servicing responsibilities. The primary servicing activities performed are administrative in nature and include remittance of payments on the loans, administration of escrow accounts, and collections of insurance claims. Upon delinquency or default by the borrower, the responsibility for administration of the loan is transferred from the transferor as the primary servicer to the special servicer. Furthermore, the special servicer, as the equity holder, has the approval rights for budgets, leases, and property managers of foreclosed properties.

55-100 The special servicer is involved in the creation of the VIE and required at the creation date that certain loans, which it deemed to be of high risk, be removed from the initial pool of loans that were going to be purchased by the VIE from the transferor. The special servicer also reviewed the VIE’s governing documents to ensure that the special servicer would be allowed to act quickly and effectively in situations in which a loan becomes delinquent. The special servicer concluded the VIE’s governing documents allowed the special servicer to adequately monitor and direct the performance of the underlying loans.

55-101 For its services as primary servicer, the transferor earns a fixed fee, calculated as a percentage of the unpaid principal balance on the underlying loans. The special servicer also earns a fixed fee, calculated as a percentage...
of the unpaid principal balance on the underlying loans. The fees paid to the primary and special servicer are both of the following:

(a) Compensation for services provided and commensurate with the level of effort required to provide the services

(b) Part of a service arrangement that includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm’s length.

No party has the ability to remove the primary servicer or the special servicer.

55-102 To evaluate the facts and circumstances and determine which reporting entity, if any, is the primary beneficiary of a VIE, paragraph 810-10-25-38A requires that a reporting entity determine the purpose and design of the VIE, including the risks that the VIE was designed to create and pass through to its variable interest holders. In making this assessment, the variable interest holders of the VIE determined the following:

(a) The primary purposes for which the VIE was created were to provide liquidity to the transferor to originate additional loans and to provide investors with the ability to invest in a pool of commercial mortgage loans.

(b) The VIE was marketed to debt investors as a VIE that would be exposed to the credit risk associated with the possible default by the borrowers with respect to principal and interest payments, with the equity tranche designed to absorb the first dollar risk of loss. Additionally, the marketing of the transaction indicated that such risks would be mitigated by subordination of the equity tranche.

(c) The VIE is not exposed to prepayment risk because the commercial mortgage loans contain provisions that require the borrower to pay the full scheduled interest and principal if the loan is extinguished prior to maturity.

55-103 The special servicer and the bondholders are the variable interest holders in the VIE. The fees paid to the transferor do not represent a variable interest on the basis of a consideration of the conditions in paragraphs 810-10-55-37 through 55-38. The fees paid to the special servicer represent a variable interest on the basis of a consideration of the conditions in those paragraphs, specifically paragraph 810-10-55-37(c), because of the special servicer holding the equity tranche. If the special servicer was only receiving fees and did not hold the equity tranche and if its related parties did not hold any variable interests in the VIE, then the fees would not be a variable interest.

55-104 Paragraph 810-10-25-38B requires that a reporting entity identify which activities most significantly impact the VIE’s economic performance and determine whether it has the power to direct those activities. The economic performance of the VIE is most significantly impacted by the performance of its underlying assets. Thus, the activities that most significantly impact the VIE’s economic performance are the activities that most significantly impact the
performance of the underlying assets. The special servicer has the ability to manage the VIE’s assets that are delinquent or in default to improve the economic performance of the VIE. Additionally, the special servicer, as the equity holder, can approve budgets, leases, and property managers on foreclosed property. The special servicing activities are performed only upon delinquency or default of the underlying assets. However, a reporting entity’s ability to direct the activities of a VIE when circumstances arise or events happen constitutes power if that ability relates to the activities that most significantly impact the economic performance of the VIE. A reporting entity does not have to exercise its power in order to have power to direct the activities of a VIE. The special servicer’s involvement in the design of the VIE does not, in isolation, result in the special servicer being the primary beneficiary of the VIE. However, in this situation, that involvement indicated that the special servicer had the opportunity and the incentive to establish arrangements that result in the special servicer being the variable interest holder with the power to direct the activities that most significantly impact the VIE’s economic performance.

55-105 The bondholders of the VIE have no voting rights and no other rights that provide them with the power to direct the activities that most significantly impact the VIE’s economic performance.

55-106 The activities that the primary servicer has the power to direct are administrative in nature and do not most significantly impact the VIE’s economic performance. In addition, the primary servicer, and its related parties, do not hold a variable interest in the VIE. Thus, the primary servicer cannot be the primary beneficiary of the VIE.

55-107 If a reporting entity has the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance, then under the requirements of paragraph 810-10-25-38A, that reporting entity also is required to determine whether it has the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE.

55-108 The special servicer, for its servicing activities, receives a fixed fee that provides it with the right to receive benefits of the VIE. The fees paid to the special servicer are both of the following:

(a) Compensation for services provided and commensurate with the level of effort required to provide the services

(b) Part of a service arrangement that includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm’s length.

Therefore, the fees meet the criteria in paragraph 810-10-25-38H, and they should not be considered for purposes of evaluating the characteristic in paragraph 810-10-25-38A(b). The special servicer, as the equity tranche holder, has the obligation to absorb losses and the right to receive benefits,
either of which could potentially be significant to the VIE. As equity tranche holder, the special servicer is the most subordinate tranche and therefore absorbs the first dollar risk of loss and has the right to receive benefits, including the VIE’s actual residual returns, if any.

55-109 On the basis of the specific facts and circumstances presented in this Case and the analysis performed, the special servicer would be deemed to be the primary beneficiary of the VIE because:

(a) It is the variable interest holder with the power to direct the activities of the VIE that most significantly impact the VIE’s economic performance.

(b) As the equity tranche holder, it has the obligation to absorb losses of the VIE and the right to receive benefits from the VIE, either of which could potentially be significant to the VIE.

Case B: Asset-Backed Collateralized Debt Obligation

55-110 A VIE is created and financed with $90 of AAA-rated fixed-rate debt securities, $6 of BB-rated fixed-rate debt securities, and $4 of equity. All debt securities issued by the VIE are held by third-party investors. The equity tranche is held 35 percent by the manager of the VIE and 65 percent by a third-party investor. The VIE uses the proceeds to purchase a portfolio of asset-backed securities with varying tenors and interest rates.

55-111 The transaction was marketed to potential debt investors as an investment in a portfolio of asset-backed securities with exposure to the credit risk associated with the possible default by the issuers of the asset-backed securities in the portfolio and to the interest rate risk associated with the management of the portfolio. The equity tranche was designed to absorb the first dollar risk of loss related to credit risk and interest rate risk and to receive any residual returns from a favorable change in interest rates or credit risk that affects the proceeds received on the sale of investments in the portfolio.

55-112 The assets of the VIE are managed within the parameters established by the underlying trust documents. The parameters provide the manager with the latitude to manage the VIE’s assets while maintaining an average portfolio rating of single B-plus or higher. If the average rating of the portfolio declines, the VIE’s governing documents require that the manager’s discretion in managing the portfolio be curtailed.

55-113 For its services, the manager earns a base, fixed fee and a performance fee in which it receives a portion of the VIE’s profit above a targeted return. The fees paid to the manager are both of the following:

(a) Compensation for services provided and commensurate with the level of effort required to provide the services

(b) Part of a service arrangement that includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm’s length.
The manager can be removed, **without cause** (as distinguished from **with cause**), by a simple majority decision of the AAA-rated debt holders. As the debt of the entity is widely disbursed, no one party has the ability to unilaterally remove the manager. If removal of the manager occurs, the manager will continue to hold a 35 percent equity interest in the VIE.

55-114 The third-party equity investor has rights that are limited to administrative matters.

55-115 To evaluate the facts and circumstances and determine which reporting entity, if any, is the primary beneficiary of a VIE, paragraph 810-10-25-38A requires that a reporting entity determine the purpose and design of the VIE, including the risks that the VIE was designed to create and pass through to its variable interest holders. In making this assessment, the variable interest holders of the VIE determined the following:

(a) The primary purposes for which the VIE was created were to provide investors with the ability to invest in a pool of asset-backed securities, to earn a positive spread between the interest that the VIE earns on its portfolio and the interest paid to the debt investors, and to generate management fees for the manager.

(b) The transaction was marketed to potential debt investors as an investment in a portfolio of asset-backed securities with exposure to the credit risk associated with the possible default by the issuers of the asset-backed securities in the portfolio and to the interest rate risk associated with the management of the portfolio. Additionally, the marketing of the transaction indicated that such risks would be mitigated by the support from the equity tranche.

(c) The equity tranche was designed to absorb the first dollar risk of loss related to credit risk and interest rate risk and to receive any residual returns from a favorable change in interest rates or credit risk that affects the proceeds received on the sale of asset-backed securities in the portfolio.

55-116 The third-party debt investors, the third-party equity investor, and the manager are the variable interest holders in the VIE. The fees paid to the manager represent a variable interest on the basis of a consideration of the conditions in paragraphs 810-10-55-37 through 55-38, specifically paragraph 810-10-55-37(c), because of the manager holding the equity tranche. If the manager was only receiving fees and did not hold the equity tranche and if its related parties did not hold any variable interests in the VIE, then the fees would not be a variable interest.

55-117 Paragraph 810-10-25-38B requires that a reporting entity identify which activities most significantly impact the VIE’s economic performance and determine whether it has the power to direct those activities. The economic performance of the VIE is most significantly impacted by the performance of the VIE’s portfolio of assets. Thus, the activities that most significantly impact
the VIE’s economic performance are the activities that most significantly impact
the performance of the portfolio of assets. The manager has the ability to
manage the VIE’s assets within the parameters of the trust documents. If the
average rating of the portfolio declines, the VIE’s governing documents require
that the manager’s discretion in managing the portfolio be curtailed. Although
the AAA-rated debt holders can remove the manager without cause, no one
party has the unilateral ability to exercise the kick-out rights over the manager.
Therefore, such kick-out rights would not be considered in this primary
beneficiary analysis.

55-118 The debt holders of the VIE do not have voting rights or other rights
that provide them with the power to direct activities that most significantly
impact the VIE’s economic performance. Although the AAA-rated debt holders
can remove the manager without cause, no one party has the unilateral ability
to exercise the kick out rights over the manager.

55-119 The third-party equity investor has the power to direct certain activities.
However, the activities that the third-party equity investor has the power to
direct are administrative and do not most significantly impact the VIE’s
economic performance.

55-120 If a reporting entity has the power to direct the activities of a VIE that
most significantly impact the VIE’s economic performance, then under the
requirements of paragraph 810-10-25-38A, that reporting entity also is required
to determine whether it has the obligation to absorb losses of the VIE that
could potentially be significant to the VIE or the right to receive benefits from
the VIE that could potentially be significant to the VIE. The manager, as the 35
percent equity tranche holder, has the obligation to absorb losses and the right
to receive benefits. As equity tranche holder, the manager has the most
subordinate tranche and therefore absorbs 35 percent of the first dollar risk of
loss and has the right to receive 35 percent of any residual benefits. The fees
paid to the manager are both of the following:

(a) Compensation for services provided and commensurate with the
level of effort required to provide the services

(b) Part of a service arrangement that includes only terms, conditions, or
amounts that are customarily present in arrangements for similar
services negotiated at arm’s length.

Therefore, the fees meet the criteria in paragraph 810-10-25-38H, and they
should not be considered for purposes of evaluating the characteristic in
paragraph 810-10-25-38A(b). Through the equity interest, the manager has the
obligation to absorb losses of the VIE that could potentially be significant to the
VIE and the right to receive benefits from the VIE that could potentially be
significant to the VIE.

55-121 On the basis of the specific facts and circumstances presented in this
Case and the analysis performed, the manager would be deemed to be the
primary beneficiary of the VIE because:
(a) It is the variable interest holder with the power to direct the activities of the VIE that most significantly impact the VIE’s economic performance (and no single entity has the unilateral ability to exercise kick-out rights).

(b) Through its equity interest, it has the obligation to absorb losses of the VIE that could potentially be significant to the VIE and the right to receive benefits from the VIE that could potentially be significant to the VIE.

Case C: Structured Investment Vehicle

55-122 A VIE is created and financed with $94 of AAA-rated fixed-rate short-term debt with a 6-month maturity and $6 of equity. The VIE uses the proceeds to purchase a portfolio of floating-rate debt with an average life of four years and varying interest rates and short-term deposits with highly rated banks. The short-term debt securities and equity are held by multiple third-party investors. Upon maturity of the short-term debt, the VIE will either refinance the debt with existing investors or reissue the debt to new investors at existing market rates.

55-123 The primary purpose of the VIE is to generate profits by maximizing the spread it earns on its asset portfolio and its weighted-average cost of funding. The transaction was marketed to potential debt investors as an investment in a portfolio of high-quality debt with exposure to the credit risk associated with the possible default by the issuers of the debt in the portfolio. The equity tranche is designed to absorb the first dollar risk of loss related to credit, liquidity, market value, and interest rate risk and to receive any benefit from a favorable change in credit, market value, and interest rates.

55-124 The VIE is exposed to liquidity risk because the average tenor of the assets is greater than its liabilities. To mitigate liquidity risk, the VIE maintains a certain portion of its assets in short-term deposits with highly rated banks. The VIE has not entered into a liquidity facility to further mitigate liquidity risk.

55-125 The sponsor of the VIE was significantly involved with the creation of the VIE. The sponsor performs various functions to manage the operations of the VIE, which include:

(a) Investment management--This management must adhere to the investment guidelines established at inception of the VIE. These guidelines include descriptions of eligible investments and requirements regarding the composition of the credit portfolio (including limits on country risk exposures, diversification limits, and ratings requirements).

(b) Funding management--This function provides funding management and operational support in relation to the debt issued and the equity with the objective of minimizing the cost of borrowing, managing interest rate and liquidity risks, and managing the capital adequacy of the VIE.
(c) Defeasance management--An event of defeasance occurs upon the failure of the rating agencies to maintain the ratings of the debt securities issued by the VIE at or above certain specified levels. In the event of defeasance, the sponsor is responsible for overseeing the orderly liquidation of the investment portfolio and the orderly discharge of the VIE’s obligations. This includes managing the market and credit risks of the portfolio.

55-126 For its services, the sponsor receives a fixed fee, calculated as an annual percentage of the aggregate equity outstanding, and a performance-based fee, calculated as a percentage of the VIE’s profit above a targeted return. The fees paid to the sponsor are both of the following:

(a) Compensation for services provided and commensurate with the level of effort required to provide the services

(b) Part of a service arrangement that includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm’s length.

55-127 The debt security holders of the VIE have no voting rights. The equity holders have limited voting rights that are typically limited to voting on amendments to the constitutional documents of the VIE.

55-128 To evaluate the facts and circumstances and determine which reporting entity, if any, is the primary beneficiary of a VIE, paragraph 810-10-25-38A requires that a reporting entity determine the purpose and design of the VIE, including the risks that the VIE was designed to create and pass through to its variable interest holders. In making this assessment, the variable interest holders of the VIE determined the following:

(a) The primary purposes for which the VIE was created were to provide investors with the ability to invest in a pool of high-quality debt, to maximize the spread it earns on its asset portfolio over its weighted-average cost of funding, and to generate management fees for the sponsor.

(b) The transaction was marketed to potential debt investors as an investment in a portfolio of high-quality debt with exposure to the credit risk associated with the possible default by the issuers of the debt in the portfolio.

(c) The equity tranche is negotiated to absorb the first dollar risk of loss related to credit, liquidity, market value, and interest rate risk and to receive a portion of the benefit from a favorable change in credit, market value, and interest rates.

(d) The principal risks to which the VIE is exposed include credit, interest rate, and liquidity risk.

55-129 The third-party debt investors, the third-party equity investors, and the sponsor are the variable interest holders in the VIE. The fees paid to the
sponsor represent a variable interest on the basis of a consideration of the conditions in paragraphs 810-10-55-37 through 55-38, specifically paragraph 810-10-55-37(c), because of the sponsor having an implicit variable interest in the VIE as discussed in paragraph 810-10-55-132. If the sponsor was only receiving fees and did not have the implicit variable interest and if its related parties did not hold any variable interests in the VIE, then the fees would not be a variable interest.

55-130 Paragraph 810-10-25-38B requires that a reporting entity identify which activities most significantly impact the VIE’s economic performance and determine whether it has the power to direct those activities. The economic performance of the VIE is significantly impacted by the performance of the VIE’s portfolio of assets and by the terms of the short-term debt. Thus, the activities that significantly impact the VIE’s economic performance are the activities that significantly impact the performance of the portfolio of assets and the terms of the short-term debt (when the debt is refinanced or reissued). The sponsor manages the VIE’s investment, funding, and defeasance activities. The fact that the sponsor was significantly involved with the creation of the VIE does not, in isolation, result in the sponsor being the primary beneficiary of the VIE. However, the fact that the sponsor was involved with the creation of the VIE indicated that the sponsor had the opportunity and the incentive to establish arrangements that result in the sponsor being the variable interest holder with the power to direct the activities that most significantly impact the VIE’s economic performance.

55-131 The debt security holders of the VIE have no voting rights and no other rights that provide them with the power to direct the activities that most significantly impact the VIE’s economic performance. Although the equity holders have voting rights, they are limited to voting on amendments to the constitutional documents of the VIE, and those rights do not provide the equity holders with the power to direct the activities that most significantly impact the VIE’s economic performance.

55-132 If a reporting entity has the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance, then under the requirements of paragraph 810-10-25-38A, that reporting entity also is required to determine whether it has the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE. The sponsor considered whether it had an implicit financial responsibility to ensure that the VIE operates as designed. Based on paragraphs 810-10-25-51 and 810-10-25-54, the sponsor determined that it has an implicit financial responsibility and that such obligation requires the sponsor to absorb losses that could potentially be significant to the VIE. This determination was influenced by the sponsor’s concern regarding the risk to its reputation in the marketplace if the VIE did not operate as designed. The fees paid to the sponsor are both of the following:
(a) Compensation for services provided and commensurate with the level of effort required to provide the services.
(b) Part of a service arrangement that includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm’s length.

Therefore, the fees meet the criteria in paragraph 810-10-25-38H, and they should not be considered for purposes of evaluating the characteristic in paragraph 810-10-25-38A(b).

55-133 On the basis of the specific facts and circumstances presented in this Case and the analysis performed, the sponsor would be deemed to be the primary beneficiary of the VIE because:

(a) It is the variable interest holder with the power to direct the activities of the VIE that most significantly impact the VIE’s economic performance.
(b) Through its implicit financial responsibility to ensure that the VIE operates as designed, it has the obligation to absorb losses of the VIE that could potentially be significant to the VIE.

Case D: Commercial Paper Conduit

55-134 A VIE is created by a reporting entity (the sponsor) and financed with $98 of AAA-rated fixed-rate short-term debt with a 3-month maturity and $2 of subordinated notes. The VIE uses the proceeds to purchase a portfolio of medium-term assets with average tenors of three years. The asset portfolio is obtained from multiple sellers. The short-term debt and subordinated notes are held by multiple third-party investors. Upon maturity of the short-term debt, the VIE will either refinance the debt with existing investors or reissue the debt to new investors.

55-135 The sponsor of the VIE provides credit enhancement in the form of a letter of credit equal to 5 percent of the VIE’s assets and it provides a liquidity facility to fund the cash flow shortfalls on 100 percent of the short-term debt. Cash flow shortfalls could arise due to a mismatch between collections on the underlying assets of the VIE and payments due to the short-term debt holders or to the inability of the VIE to refinance or reissue the short-term debt upon maturity.

55-136 A credit default of the VIE’s assets resulting in deficient cash flows is absorbed as follows:

(a) First by the subordinated note holders
(b) Second by the sponsor’s letter of credit
(c) Third by the short-term debt holders.

The sponsor’s liquidity facility does not advance against defaulted assets.
55-137 The VIE is exposed to liquidity risk because the average life of the assets is greater than that of its liabilities. The VIE enters into a liquidity facility with the sponsor to mitigate liquidity risk.

55-138 The transaction was marketed to potential debt investors as an investment in a portfolio of highly rated medium-term assets with minimal exposure to the credit risk associated with the possible default by the issuers of the assets in the portfolio. The subordinated notes were designed to absorb the first dollar risk of loss related to credit. The VIE is marketed to all investors as having a low probability of credit exposure due to the nature of the assets obtained. Furthermore, the VIE is marketed to the short-term debt holders as having protection from liquidity risk due to the liquidity facility provided by the sponsor.

55-139 The sponsor of the VIE performs various functions to manage the operations of the VIE. Specifically, the sponsor:

(a) Establishes the terms of the VIE
(b) Approves the sellers permitted to sell to the VIE
(c) Approves the assets to be purchased by the VIE
(d) Makes decisions regarding the funding of the VIE including determining the tenor and other features of the short-term debt issued
(e) Administers the VIE by monitoring the assets, arranging for debt placement, compiling monthly reports, and ensuring compliance with the VIE’s credit and investment policies.

55-140 For providing the letter of credit, liquidity facility, and management services, the sponsor receives fixed fees that are calculated as an annual percentage of the asset value. The short-term debt holders and subordinated note holders have no voting rights. The fees paid to the sponsor for its management services are both of the following:

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

55-141 To evaluate the facts and circumstances and determine which reporting entity, if any, is the primary beneficiary of a VIE, paragraph 810-10-25-38A requires that a reporting entity determine the purpose and design of the VIE, including the risks that the VIE was designed to create and pass through to its variable interest holders. In making this assessment, the variable interest holders of the VIE determined the following:

(a) The primary purposes for which the VIE was created were to provide investors with the ability to invest in a pool of highly rated medium-
term assets, to provide the multiple sellers to the VIE with access to lower-cost funding, to earn a positive spread between the interest that the VIE earns on its asset portfolio and its weighted-average cost of funding, and to generate fees for the sponsor.

(b) The transaction was marketed to potential debt investors as an investment in a portfolio of highly rated medium-term assets with minimal exposure to the credit risk associated with the possible default by the issuers of the assets in the portfolio. The subordinated debt is designed to absorb the first dollar risk of loss related to credit and interest rate risk. The VIE is marketed to all investors as having a low probability of credit loss due to the nature of the assets obtained. Furthermore, the VIE is marketed to the short-term debt holders as having protection from liquidity risk due to the liquidity facility provided by the sponsor.

(c) The principal risks to which the VIE is exposed include credit, interest rate, and liquidity.

55-142 The short-term debt holders, the third-party subordinated note holders, and the sponsor are the variable interest holders in the VIE. The letter of credit and liquidity facility provided by the sponsor protect holders of other variable interests from suffering losses of the VIE. Therefore, the sponsor’s fees for the letter of credit and liquidity facility are not eligible for the evaluation in paragraph 810-10-55-37 and are variable interests in the VIE. The fees paid to the sponsor for its management services represent a variable interest on the basis of a consideration of the conditions in paragraphs 810-10-55-37 through 55-38, specifically paragraph 810-10-55-37(c), because of the sponsor providing the letter of credit and liquidity facility and the fees for the letter of credit and liquidity facility. If the sponsor was only receiving management fees, did not provide the letter of credit and liquidity facility, and did not receive fees for the letter of credit and liquidity facility and if its related parties did not hold any variable interests in the VIE, then the management fees would not be a variable interest.

55-143 Paragraph 810-10-25-38B requires that a reporting entity identify which activities most significantly impact the VIE’s economic performance and determine whether it has the power to direct those activities. The economic performance of the VIE is significantly impacted by the performance of the VIE’s portfolio of assets and by the terms of the short-term debt. Thus, the activities that significantly impact the VIE’s economic performance are the activities that significantly impact the performance of the portfolio of assets and the terms of the short-term debt (when the debt is refinanced or reissued). The sponsor manages the operations of the VIE. Specifically, the sponsor establishes the terms of the VIE, approves the sellers permitted to sell to the VIE, approves the assets to be purchased by the VIE, makes decisions about the funding of the VIE including determining the tenor and other features of the short-term debt issued, and administers the VIE by monitoring the assets, arranging for debt placement, and ensuring compliance with the VIE’s credit
and investment policies. The fact that the sponsor was significantly involved with the creation of the VIE does not, in isolation, result in the sponsor being the primary beneficiary of the VIE. However, the fact that the sponsor was involved with the creation of the VIE may indicate that the sponsor had the opportunity and the incentive to establish arrangements that result in the sponsor being the variable interest holder with the power to direct the activities that most significantly impact the VIE’s economic performance.

55-144 The short-term debt holders and subordinated note holders of the VIE have no voting rights and no other rights that provide them with power to direct the activities that most significantly impact the VIE’s economic performance.

55-145 If a reporting entity has the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance, then under the requirements of paragraph 810-10-25-38A, that reporting entity also is required to determine whether it has the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE. The fees paid to the sponsor for its management services are both of the following:

(a) Compensation for services provided and commensurate with the level of effort required to provide the services

(b) Part of a service arrangement that includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm’s length.

Therefore, the management fees meet the criteria in paragraph 810-10-25-38H, and they should not be considered for purposes of evaluating the characteristic in paragraph 810-10-25-38A(b). However, the sponsor still, through its letter of credit and liquidity facility fees, receives benefits from the VIE that could potentially be significant to the VIE. The sponsor, through its letter of credit and liquidity facility, also has the obligation to absorb losses of the VIE that could potentially be significant to the VIE.

55-146 On the basis of the specific facts and circumstances presented in this Case and the analysis performed, the sponsor would be deemed to be the primary beneficiary of the VIE because:

(a) It is the variable interest holder with the power to direct the activities of the VIE that most significantly impact the VIE’s economic performance.

(b) Through its letter of credit and liquidity facility, the sponsor has the obligation to absorb losses that could potentially be significant to the VIE, and, through its fees for the letter of credit and liquidity facility, the sponsor has the right to receive benefits that could potentially be significant to the VIE.
Case E: Guaranteed Mortgage-Backed Securitization

55-147 A VIE is created and financed with $100 of a single class of investment-grade 30-year fixed-rate debt securities. The VIE uses the proceeds to purchase $100 of 30-year fixed-rate residential mortgage loans from the transferor. The VIE enters into a guarantee facility that absorbs 100 percent of the credit losses incurred on the VIE’s assets. The assets acquired by the VIE are underwritten by the transferor in accordance with the parameters established by the guarantor. Additionally, all activities of the VIE are prespecified by the trust agreement and servicing guide, which are both established by the guarantor. No critical decisions are generally required for the VIE unless default of an underlying asset is reasonably foreseeable or occurs.

55-148 The transaction was marketed to potential debt security holders as an investment in a portfolio of residential mortgage loans with exposure to the credit risk of the guarantor and to the prepayment risk associated with the underlying loans of the VIE. Each month, the security holders receive interest and principal payments in proportion to their percentage ownership of the underlying loans.

55-149 If there is a shortfall in contractually required loan payments from the borrowers or if the loan is foreclosed on and the liquidation of the underlying property does not generate sufficient proceeds to meet the required payments on all securities, the guarantor will make payments to the debt securities holders to ensure timely payment of principal and accrued interest on the debt securities.

55-150 The guarantor also serves as the master servicer for the VIE. As master servicer, the guarantor services the securities issued by the VIE. Generally, if a mortgage loan is 120 days (or 4 consecutive months) delinquent, and if other circumstances are met, the guarantor has the right to buy the loan from the VIE. The master servicer can only be removed for a material breach in its obligations. As compensation for the guarantee and services provided, the guarantor receives a fee that is calculated monthly as a percentage of the unpaid principal balance on the underlying loans.

55-151 As master servicer, the guarantor also is responsible for supervising and monitoring the servicing of the residential mortgage loans (primary servicing). The VIE’s governing documents provide that the guarantor is responsible for the primary servicing of the loans; however, the guarantor is allowed to, and does, hire the transferor to perform primary servicing activities that are conducted under the supervision of the guarantor. The guarantor monitors the primary servicer’s performance and has the right to remove the primary servicer at any time it considers such a removal to be in the best interest of the security holders.

55-152 The primary servicing activities are performed under the servicing guide established by the guarantor. Examples of the primary servicing activities include collecting and remitting principal and interest payments, administering
escrow accounts, and managing default. When a loan becomes delinquent or it is reasonably foreseeable of becoming delinquent, the primary servicer can propose a default mitigation strategy in which the guarantor can approve, reject, or require another course of action if it considers such action is in the best interest of the security holders. As compensation for servicing the underlying loans, the transferor receives a fee that is calculated monthly as a percentage of the unpaid principal balance on the underlying loans.

55-153 To evaluate the facts and circumstances and determine which reporting entity, if any, is the primary beneficiary of a VIE, paragraph 810-10-25-38A requires that a reporting entity determine the purpose and design of the VIE, including the risks that the VIE was designed to create and pass through to its variable interest holders. In making this assessment, the variable interest holders of the VIE determined the following:

(a) The primary purposes for which the VIE was created were to provide investors with the ability to invest in a pool of residential mortgage loans with a third-party guarantee for 100 percent of the principal and interest payments due on the mortgage loans in the VIE, to provide the transferor to the VIE with access to liquidity for its originated loans and an ongoing servicing fee, and to generate fees for the guarantor.

(b) The transaction was marketed to potential debt security holders as an investment in a portfolio of residential mortgage loans with exposure to the credit risk of the guarantor and prepayment risk associated with the underlying assets of the VIE.

(c) The principal risks to which the VIE is exposed include credit risk of the underlying assets, prepayment risk, and the risk of fluctuations in the value of the underlying real estate. The credit risk of the underlying assets and the risk of fluctuations in the value of the underlying real estate are fully absorbed by the guarantor.

55-154 The debt securities holders and the guarantor are the variable interest holders in the VIE. The fees paid to the transferor do not represent a variable interest on the basis of a consideration of the conditions in paragraphs 810-10-55-37 through 55-38. The guarantee arrangement protects holders of other variable interests from suffering losses in the VIE because the guarantor is required to fully absorb the credit risk of the underlying assets of the VIE and the risk of fluctuations in the value of the underlying real estate. Therefore, the guarantor’s fees are not eligible for the evaluation in paragraph 810-10-55-37.

55-155 Paragraph 810-10-25-38B requires that a reporting entity identify which activities most significantly impact the VIE’s economic performance and determine whether it has the power to direct those activities. The economic performance of the VIE is most significantly impacted by the performance of its underlying assets. Thus, the activities that most significantly impact the VIE’s economic performance are the activities that most significantly impact the performance of the underlying assets. The guarantor, who is also the master...
servicer, has the ability (through establishment of the servicing terms, to appoint and remove the primary servicer, to direct default mitigation, and to purchase defaulted assets) to manage the VIE’s assets that become delinquent (or may become delinquent in the reasonably foreseeable future) to improve the economic performance of the VIE.

55-156 Prepayment risk is also a risk that the VIE was designed to create and pass through. However, no variable interest holder has the power to direct activities related to such risk.

55-157 Because the guarantor is able to appoint and replace the primary servicer and direct default mitigation, the primary servicer does not have the power to direct the activities that most significantly impact the VIE’s economic performance. In addition, the primary servicer and its related parties do not hold a variable interest in the VIE. Thus, the primary servicer cannot be the primary beneficiary of the VIE. Furthermore, the security holders have no voting rights and, thus, no power to direct the activities that most significantly impact the VIE’s economic performance.

55-158 If a reporting entity has the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance, then under the requirements of paragraph 810-10-25-38A, that reporting entity also is required to determine whether it has the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE. The guarantor, through its fee arrangement, receives benefits, which may or may not potentially be significant under this analysis; however, the guarantor has the obligation to absorb losses of the VIE that could potentially be significant through its guarantee obligation. Therefore, the fees are not eligible for the evaluation in paragraph 810-10-25-38H, and they should be considered for purposes of evaluating the characteristic in paragraph 810-10-25-38A(b).

55-159 On the basis of the specific facts and circumstances presented in this Case and the analysis performed, the guarantor would be deemed to be the primary beneficiary of the VIE because:

- (a) It is the variable interest holder with the power to direct the activities of the VIE that most significantly impact the VIE’s economic performance.
- (b) Through its guarantee, it has the obligation to absorb losses of the VIE that could potentially be significant to the VIE.

Case F: Residential Mortgage-Backed Securitization

55-160 A VIE is created and financed with $100 of 30-year fixed-rate debt securities. The securities are issued in 2 tranches (a $90 senior tranche and a $10 residual tranche). The senior tranche securities are investment grade and are widely dispersed among third-party investors. The residual tranche securities are held by the transferor. The VIE uses the proceeds to purchase $100 of 30-year fixed-rate residential mortgage loans from a transferor. A
default on the underlying loans is absorbed first by the residual tranche held by the transferor. All activities of the VIE are prespecified by a pooling and servicing agreement for the transaction. No critical decisions are generally required for the VIE unless default of an underlying asset is reasonably foreseeable or occurs.

55-161 The transaction was marketed to potential senior debt security holders as an investment in a portfolio of residential mortgage loans with exposure to the credit risk of the underlying loan borrowers and to the prepayment risk associated with the underlying loans of the VIE. Each month the security holders receive interest and principal payments in proportion to their percentage of ownership of the underlying loans. The residual tranche was designed to provide a credit enhancement to the transaction and to absorb the first dollar risk of loss related to credit.

55-162 The primary servicing responsibilities are retained by the transferor. No party has the ability to remove the transferor as servicer.

55-163 The servicing activities are performed in accordance with the pooling and servicing agreement. Examples of the servicing activities include collecting and remitting principal and interest payments, administering escrow accounts, monitoring overdue payments, and overall default management. Default management includes evaluating the borrower’s financial condition to determine which loss mitigation strategy (specified in the pooling and servicing agreement) will maximize recoveries on a particular loan. The acceptable default management strategies are limited to the actions specified in the pooling and servicing agreement and include all of the following:

(a) Modifying the terms of loans when default is reasonably foreseeable

(b) Temporary forbearance on collections of principal and interest (such amounts would be added to the unpaid balance on the loan)

(c) Short sales in which the servicer allows the underlying borrower to sell the mortgaged property even if the anticipated sale price will not permit full recovery of the contractual loan amounts.

55-164 As compensation for servicing the underlying loans, the transferor receives a fee, calculated monthly as a percentage of the unpaid principal balance on the underlying loans. Although the servicing activities, particularly managing default, are required to be performed in accordance with the pooling and servicing agreement, the transferor, as servicer, has discretion in determining which strategies within the pooling and servicing agreement to utilize to attempt to maximize the VIE’s economic performance. The fees paid to the transferor are both of the following:

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

55-165 To evaluate the facts and circumstances and determine which reporting entity, if any, is the primary beneficiary of a VIE, paragraph 810-10-25-38A requires that a reporting entity determine the purpose and design of the VIE, including the risks that the VIE was designed to create and pass through to its variable interest holders. In making this assessment, the variable interest holders of the VIE determined the following:

(a) The primary purposes for which the VIE was created were to provide investors with the ability to invest in a pool of residential mortgage loans and to provide the transferor to the VIE with access to liquidity for its originated loans and an ongoing servicing fee and potential residual returns.

(b) The transaction was marketed to potential senior debt security holders as an investment in a portfolio of residential mortgage loans with credit enhancement provided by the residual tranche and prepayment risk associated with the underlying assets of the VIE. The marketing of the transaction indicated that credit risk would be mitigated by the subordination of the residual tranche.

(c) The principal risks to which the VIE is exposed include credit of the underlying assets, prepayment risk, and the risk of fluctuations in the value of the underlying real estate.

55-166 The debt security holders and the transferor are the variable interest holders in the VIE. The fee paid to the transferor (in its role as servicer) represents a variable interest on the basis of a consideration of the conditions in paragraphs 810-10-55-37 through 55-38, specifically paragraph 810-10-55-37(c), because of the transferor holding the residual tranche. If the transferor was only receiving fees and did not hold the residual tranche and if its related parties did not hold any variable interests in the VIE, then the fees would not be a variable interest.

55-167 Paragraph 810-10-25-38B requires that a reporting entity identify which activities most significantly impact the VIE’s economic performance and determine whether it has the power to direct those activities. The economic performance of the VIE is most significantly impacted by the performance of its underlying assets. Thus, the activities that most significantly impact the VIE’s economic performance are the activities that most significantly impact the performance of the underlying assets. The transferor, as servicer, has the ability to manage the VIE’s assets that become delinquent (or are reasonably foreseeable of becoming delinquent) to improve the economic performance of the VIE. Additionally, no party can remove the transferor in its role as servicer. The default management activities are performed only after default of the underlying assets or when default is reasonably foreseeable. However, a reporting entity’s ability to direct the activities of a VIE when circumstances
arise or events happen constitutes power if that ability relates to the activities that most significantly impact the economic performance of the VIE. A reporting entity does not have to exercise its power in order to have power to direct the activities of a VIE.

55-168 Prepayment risk is also a risk that the VIE was designed to create and pass through. However, no variable interest holder has the power to direct matters related to such risk.

55-169 The senior security holders have no voting rights and, thus, no power to direct the activities that most significantly impact the VIE’s economic performance.

55-170 If a reporting entity has the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance, then under the requirements of paragraph 810-10-25-38A, that reporting entity also is required to determine whether it has the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE. The transferor, through its residual tranche ownership, has the obligation to absorb losses and the right to receive benefits, either of which could potentially be significant to the VIE. The fees paid to the transferor are both of the following:

(a) Compensation for services provided and commensurate with the level of effort required to provide those services

(b) Part of a service arrangement that includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm’s length.

Therefore, the fees meet the criteria in paragraph 810-10-25-38H and should not be considered for purposes of evaluating the characteristic in paragraph 810-10-25-38A(b).

55-171 On the basis of the specific facts and circumstances presented in this Case and the analysis performed, the transferor would be deemed to be the primary beneficiary of the VIE because:

(a) It is the variable interest holder with the power to direct the activities of the VIE that most significantly impact the VIE’s economic performance.

(b) Through its residual tranche ownership, it has the obligation to absorb losses and the right to receive benefits, either of which could potentially be significant to the VIE.

Case G: Property Lease Entity

55-172 A VIE is created and financed with $950 of 5-year fixed-rate debt and $50 of equity. The VIE uses the proceeds from the issuance to purchase property to be leased to a lessee with an AA credit rating. The equity is subordinate to the debt because the debt is paid before any cash flows are available to the equity investors. The lease has a five-year term and is
classified as a direct finance lease by the lessor and as an operating lease by the lessee. The lessee, however, is considered the owner of the property for tax purposes and, thus, receives tax depreciation benefits.

**55-173** The lessee is required to provide a first-loss residual value guarantee for the expected future value of the leased property at the end of five years (the option price) up to a specified percentage of the option price, and it has a fixed-price purchase option to acquire the property for the option price. If the lessee does not exercise the fixed-price purchase option at the end of the lease term, the lessee is required to remarket the property on behalf of the VIE. If the property is sold for an amount less than the option price, the lessee is required to pay the VIE the difference between the option price and the sales proceeds, which is not to exceed a specified percentage of the option price. If the property is sold for an amount greater than the option price, the lessee is entitled to the excess of the sales proceeds over the option price. A third-party residual value guarantor provides a very small additional residual value guarantee to the lessor VIE, which allows the lessor to achieve direct financing lease treatment.

**55-174** The governing documents for the VIE do not permit the VIE to buy additional assets or sell existing assets during the five-year holding period, and the terms of the lease agreement and the governing documents for the VIE do not provide the equity holders with the power to direct any activities of the VIE. The VIE was formed so that the lessee would have rights to use the property under an operating lease and would retain substantially all of the risks and rewards from appreciation or depreciation in value of the leased property.

**55-175** The transaction was marketed to potential investors as an investment in a portfolio of AA-rated assets collateralized by leased property that would provide a fixed-rate return to debt holders equivalent to AA-rated assets. The return to equity investors is expected to be slightly greater than the return to the debt investors because the equity is subordinated to the debt.

**55-176** To evaluate the facts and circumstances and determine which reporting entity, if any, is the primary beneficiary of a VIE, paragraph 810-10-25-38A requires that a reporting entity determine the purpose and design of the VIE, including the risks that the VIE was designed to create and pass through to its variable interest holders. In making this assessment, the variable interest holders of the VIE determined the following:

(a) The primary purpose for which the VIE was created was to provide the lessee with use of the property for five years with substantially all of the rights and obligations of ownership, including tax benefits.

(b) The VIE was marketed to potential investors as an investment in a portfolio of AA-rated assets collateralized by leased property that would provide a fixed-rate return to debt holders equivalent to AA-rated assets. The return to equity investors is expected to be slightly
greater than the return to the debt investors because the equity is subordinated to the debt.

(c) The residual value guarantee effectively transfers substantially all of the risk associated with the underlying property (that is, decreases in value) to the lessee and the fixed-price purchase option effectively transfers substantially all of the rewards from the underlying property (that is, increases in value) to the lessee.

(d) The VIE is designed to be exposed to the risks associated with a cumulative change in fair value of the leased property at the end of five years as well as credit risk related to the potential default by the lessee of its contractually required lease payments.

55-177 The debt investors, the equity investors, and the lessee are the variable interest holders in the VIE.

55-178 Paragraph 810-10-25-38B requires that a reporting entity identify which activities most significantly impact the VIE’s economic performance and determine whether it has the power to direct those activities. The economic performance of the VIE is significantly impacted by the fair value of the underlying property and the credit of the lessee. The lessee’s maintenance and operation of the leased property has a direct effect on the fair value of the underlying property, and the lessee directs the remarketing of the property. The lessee also has the ability to increase the benefits it can receive and limit the losses it can suffer by the manner in which it uses the property and how it remarkets the property.

55-179 The debt holders do not have the power to direct activities that most significantly impact the VIE’s economic performance. Although the equity holders establish the terms of the lease agreement, the terms of the lease agreement do not provide the equity holders with the power to direct activities that most significantly impact the VIE’s economic performance.

55-180 If a reporting entity has the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance, then under the requirements of paragraph 810-10-25-38A, that reporting entity also is required to determine whether it has the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE. The lessee has both the obligation to absorb losses that could potentially be significant to the VIE and the right to receive benefits that could potentially be significant to the VIE through the residual value guarantee and the purchase option, respectively.

55-181 On the basis of the specific facts and circumstances presented in this Case and the analysis performed, the lessee would be deemed the primary beneficiary of the VIE because:

It is the variable interest holder with the power to direct the activities of the VIE that most significantly impact the VIE’s economic performance.
Through its residual value guarantee and purchase option, it has the obligation to absorb losses of the VIE that could potentially be significant to the VIE and the right to receive benefits from the VIE that could potentially be significant to the VIE.

Case H: Collaboration--Joint Venture Arrangement

55-182 The following Cases illustrate the application of the guidance in paragraphs 810-10-25-38A through 25-38J related to the determination of the entity that has the power to direct the activities of the VIE that most significantly impact the VIE’s economic performance.

(a) Joint decision making, different activities (Case H1)
(b) Separate decision making, different activities (Case H2)
(c) Separate decision making, same activities (Case H3)
(d) Separate decision making, similar and different activities (Case H4).

55-183 Each of the Cases share the following assumptions:

(a) Reporting Entity A and Reporting Entity B form a VIE to manufacture, distribute, and sell a beverage. The VIE is funded with $95 million of 20-year fixed-rate debt and $5 million of equity. The debt is widely dispersed among third-party investors. The equity is held by Reporting Entity A and Reporting Entity B. Reporting Entity A and Reporting Entity B are not related parties.

(b) Reporting Entity A and Reporting Entity B each have 50 percent of the voting rights and each represents 50 percent of the board of directors.

(c) Reporting Entity A is a beverage manufacturer and distributor. Reporting Entity B is also a beverage manufacturer and distributor.

Case H1: Joint Decision Making, Different Activities

55-184 Reporting Entity A is responsible for manufacturing the beverage. Reporting Entity B is responsible for distributing and selling the beverage. Decisions about the manufacturing, distributing, and selling of the beverage require the consent of both Reporting Entity A and Reporting Entity B. All other decisions about the VIE are jointly decided by Reporting Entity A and Reporting Entity B through their voting interests and equal board representation. Any matters that cannot be resolved or agreed upon must be resolved through a third-party arbitration process.

55-185 To evaluate the facts and circumstances and determine which reporting entity, if any, is the primary beneficiary of a VIE, paragraph 810-10-25-38A requires that a reporting entity determine the purpose and design of the VIE, including the risks that the VIE was designed to create and pass through to its variable interest holders. In making this assessment, the variable interest holders of the VIE determined that the primary purpose for which the VIE was created was to provide Reporting Entity A with access to Reporting Entity B’s...
distribution and sales network and for Reporting Entity B to gain access to Reporting Entity A’s manufacturing process and technology.

55-186 Reporting Entity A and Reporting Entity B (through their equity investment) and the debt investors are the variable interest holders in the VIE.

55-187 Paragraph 810-10-25-38B requires that a reporting entity identify which activities most significantly impact the VIE’s economic performance and determine whether it has the power to direct those activities. The economic performance of the VIE is significantly impacted by the manufacturing of the beverage and by the selling and distributing of the beverage. Thus, the activities that significantly impact the VIE’s economic performance are the activities that significantly impact the manufacturing of the beverage and the selling and distributing of the beverage.

55-188 Paragraph 810-10-25-38D provides that if a reporting entity determines that power is, in fact, shared among multiple parties such that no one party has the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance, then no party is the primary beneficiary. Power is shared if two or more unrelated parties together have the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance, and if decisions about those activities require the consent of each of the parties sharing power.

55-189 Reporting Entity A and Reporting Entity B share the power to direct the activities that will most significantly impact the economic performance of the VIE through their ability to make decisions about the manufacturing, distributing, and selling of the beverage and because of the fact that those decisions require each party’s consent.

55-190 The debt holders of the VIE have no voting rights and no other rights that provide them with the power to direct the activities that most significantly impact the VIE’s economic performance.

55-191 If a reporting entity has the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance, then under the requirements of paragraph 810-10-25-38A, that reporting entity also is required to determine whether it has the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE. Reporting Entity A and Reporting Entity B both have the obligation to absorb losses and the right to receive benefits that could potentially be significant to the VIE through their equity interests.

55-192 On the basis of the specific facts and circumstances presented in this Case and the analysis performed, the VIE does not have a primary beneficiary because the power to direct the activities of the VIE that most significantly impact the VIE’s economic performance, is, in fact, shared among multiple parties (Reporting Entity A and Reporting Entity B) such that no one party has
the power to direct the activities of the VIE that most significantly impact the VIE’s economic performance.

**Case H2: Separate Decision Making, Different Activities**

**55-193** Assume that decisions about the manufacturing, distributing, and selling of the beverage do not require the consent of both Reporting Entity A and Reporting Entity B. Each reporting entity would be required to identify which activities most significantly impact the VIE’s economic performance and determine whether it has the power to direct those activities. The party with the power to direct those activities would be the primary beneficiary of the VIE. Because decisions about these activities do not require the consent of both Reporting Entity A and Reporting Entity B, power would not be considered shared, and either Reporting Entity A or Reporting Entity B would be the primary beneficiary of the VIE, on the basis of which party has the power to direct the activities of the VIE that most significantly impact the VIE’s economic performance.

**Case H3: Separate Decision Making, Same Activities**

**55-194** Assume that Reporting Entity A and Reporting Entity B each manufacture, distribute, and sell the beverage in different locations, but decisions about these activities do not require the consent of both Reporting Entity A and Reporting Entity B. That is, each reporting entity is responsible for the same activities. Because decisions about these activities do not require the consent of both Reporting Entity A and Reporting Entity B, power would not be considered shared.

**55-195** If a reporting entity concludes that power is not shared but the activities that most significantly impact the VIE’s economic performance are directed by multiple unrelated parties and the nature of the activities that each party is directing is the same, the party, if any, with the power over the majority of those activities shall be considered to have the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance. If no party directs the majority of those activities, the VIE does not have a primary beneficiary.

**55-196** If Reporting Entity A or Reporting Entity B has power over the majority of those activities, then that party would be the primary beneficiary of the VIE.

**Case H4: Separate Decision Making, Similar and Different Activities**

**55-197** Assume that Reporting Entity A and Reporting Entity B are each responsible for manufacturing the beverage, but Reporting Entity B is also responsible for all of the distributing and selling of the beverage, and decisions about the manufacturing, distributing, and selling of the beverage do not require the consent of both Reporting Entity A and Reporting Entity B. Each reporting entity would be required to identify which activities most significantly impact the VIE’s economic performance and determine whether it has the power to direct those activities. The party with the power to direct those activities would be the primary beneficiary of the VIE. That is, power would not
be considered shared, and either Reporting Entity A or Reporting Entity B would be the primary beneficiary of the VIE. However, if a reporting entity concludes that power is not shared but the activities that most significantly impact the VIE’s economic performance are directed by multiple unrelated parties and the nature of the activities that each party is directing is the same, the party, if any, with the power over the majority of those activities shall be considered to have the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance. If no party directs the majority of those activities, the VIE does not have a primary beneficiary.

55-198 Reporting Entity B may conclude that its power over some of the manufacturing of the beverage, combined with its power over all of the distributing and selling of the beverage, results in its being the party with the power to direct the activities that most significantly impact the VIE’s economic performance. However, if Reporting Entity B were to conclude that the distributing and selling of the beverage did not significantly impact the economic performance of the VIE, then the primary beneficiary of the VIE would be the party, if any, with the power over the majority of the manufacturing of the beverage.

Case I: Furniture Manufacturing Entity

55-199 A VIE is created by a furniture manufacturer and a financial investor to manufacture and sell wood furniture to retail customers in a particular geographic region. The VIE was created because the furniture manufacturer has no viable distribution channel in that particular geographic region. The VIE is established with $100 of equity, contributed by the furniture manufacturer, and $3 million of 10-year fixed-rate debt, provided by a financial investor. The furniture manufacturer establishes the sales and marketing strategy of the VIE, manages the day-to-day activities of the VIE, and is responsible for preparing and implementing the annual budget for the VIE. The VIE has a distribution contract with a third party that does not represent a variable interest in the VIE. Interest is paid to the fixed-rate debt holder (the financial investor) from operations before funds are available to the equity holder. The furniture manufacturer has guaranteed the fixed-rate debt to the financial investor. The debt agreement includes a clause such that if there is a materially adverse change that materially impairs the ability of the VIE and the furniture manufacturer to pay the debt, then the financial investor can take possession of all the assets of the VIE. An independent third party must objectively determine whether a materially adverse change has occurred on the basis of the terms of the debt agreement (an example of a materially adverse change under the debt agreement is the bankruptcy of the VIE).

55-200 To evaluate the facts and circumstances and determine which reporting entity, if any, is the primary beneficiary of a VIE, paragraph 810-10-25-38A requires that a reporting entity determine the purpose and design of the VIE, including the risks that the VIE was designed to create and pass through to its
variable interest holders. In making this assessment, the variable interest holders of the VIE determined the following:

(a) The primary purpose for which the VIE was created was to enable the furniture manufacturer to extend its existing business line into a particular geographic region that lacked a viable distribution channel.

(b) The VIE was marketed to the financial investor as a fixed-rate investment in a retail operating entity, supported by the furniture manufacturer’s expertise and guarantee.

(c) The furniture manufacturer’s guarantee of the debt effectively transfers all of the operating risk of the VIE to the furniture manufacturer.

55-201 The furniture manufacturer and the financial investor (debt holder) are the variable interest holders in the VIE.

55-202 Paragraph 810-10-25-38B requires that a reporting entity identify which activities most significantly impact the VIE’s economic performance and determine whether it has the power to direct those activities. The economic performance of the VIE is most significantly impacted by the operations of the VIE because the operating cash flows of the VIE are used to repay the financial investor. Thus, the activities that most significantly impact the VIE’s economic performance are the operating activities of the VIE. The furniture manufacturer has the ability to establish the sales and marketing strategy of the VIE and manage the day-to-day activities of the VIE.

55-203 The debt holder has the power to take possession of all of the assets of the VIE if there is a materially adverse change under the debt agreement. However, the debt holder’s rights under the materially adverse change clause represent protective rights. Protective rights held by other parties do not preclude a reporting entity from having the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance. Protective rights are designed to protect the interests of the party holding those rights without giving that party a controlling financial interest in the VIE to which they relate. The debt holder’s rights protect the interests of the debt holder; however, the VIE’s economic performance is most significantly impacted by the activities over which the furniture manufacturer has power. The debt holder’s protective rights do not prevent the furniture manufacturer from having the power to direct the activities of the VIE that most significantly impact the VIE’s economic performance.

55-204 If a reporting entity has the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance, then under the requirements of paragraph 810-10-25-38A, that reporting entity also is required to determine whether it has the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits that could potentially be significant to the VIE. The furniture manufacturer has the obligation to absorb losses that could potentially be significant through its
equity interest and debt guarantee and the right to receive benefits that could potentially be significant through its equity interest.

55-205 On the basis of the specific facts and circumstances presented in this Case and the analysis performed, the furniture manufacturer would be the primary beneficiary of the VIE because:

(a) It is the variable interest holder with the power to direct the activities of the VIE that most significantly impact the VIE’s economic performance.

(b) Through its equity interest and debt guarantee, it has the obligation to absorb losses of the VIE that could potentially be significant to the VIE and the right to receive benefits from the VIE that could potentially be significant to the VIE.

Case J: Investment Fund 1—Annual and Performance-Based Fees and Additional Interests

55-205L A fund manager (general partner) creates and sells partnership interests in an investment fund (limited partnership) to external investors (limited partners). The partnership interests were marketed to the limited partners as an opportunity to generate returns by allowing the general partner to have discretion to determine how to invest the fund’s assets provided that the investments are consistent with the defined parameters and objectives set forth in the limited partnership agreement. The general partner is not liable for any losses beyond the interest that the general partner owns in the fund. The general partner’s ownership interests in the fund are expected to absorb more than an insignificant amount of the fund’s expected losses and receive more than an insignificant amount of the fund’s expected residual returns.

55-205M The individual limited partners do not hold any substantive rights that would affect the decision-making authority of the general partner, but they can redeem their interests within particular limits set forth by the fund. The limited partners do not have either of the following abilities:

(a) The ability to remove the general partner from its decision-making authority or to dissolve (liquidate) the fund without cause (as distinguished from with cause)

(b) The ability to block or participate in certain significant financial and operating decisions of the limited partnership that are made in the ordinary course of business.

55-205N The at-risk equity holders (as a group) do not have the ability to direct the activities that most significantly impact the economic performance of the fund on the basis of paragraph 810-10-55-205M(a) through (b). Therefore, the fund is a VIE because the condition in paragraph 810-10-15-14(b)(1)(ii) is met.

55-205O The general partner is paid an annual fixed fee for the assets under management and a performance-based fee based on the fund’s profits if it
achieves a specified annual profit level. The annual and performance-based fees paid to the general partner are both of the following:

(a) Compensation for services provided and commensurate with the level of effort required to provide those services

(b) Part of a compensation arrangement that includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm’s length.

55-205P To evaluate the facts and circumstances and determine which reporting entity, if any, is the primary beneficiary of a VIE, paragraph 810-10-25-38A requires that a reporting entity determine the purpose and design of the VIE, including the risks that the VIE was designed to create and pass through to its variable interest holders. In making this assessment, the variable interest holders of the VIE determined all of the following:

(a) The fund is designed to provide limited partners with exposure to the risks and returns of the fund.

(b) The fund was marketed to potential investors as an investment in a pool of securities with exposure to specific enterprise risks, market liquidity, and general market volatility of the investments. The limited partners have granted the general partner power to direct the activities that most significantly impact the VIE’s economic performance, which include management of their invested capital, on the basis of the prior performance of the general partner.

(c) The fee structure is designed to provide greater compensation to the general partner if the fund generates returns for the third-party limited partners that are above the specified profit level. The specified profit level is based on the activities of the fund and the nature of the fund’s assets. While the general partner’s fee structure may provide an incentive for the general partner to take additional risk to realize its performance-based fee, the annual and performance-based fees are designed to do all of the following:

(1) Provide compensation to the general partner for its services that is commensurate with the level of effort required to provide the services

(2) Include only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm’s length.

55-205Q The general partner and the limited partners are the variable interest holders in the VIE. The fees paid to the general partner (in its role as fund manager) represent a variable interest on the basis of a consideration of the conditions in paragraphs 810-10-55-37 through 55-38, specifically paragraph 810-10-55-37(c), because of the general partner holding ownership interests that are expected to absorb more than an insignificant amount of the fund’s expected losses and receive more than an insignificant amount of the fund’s
expected residual returns. If the general partner was only receiving fees and did not hold ownership interests and if its related parties did not hold any variable interests in the VIE, then the fees would not be a variable interest.

55-205R Paragraph 810-10-25-38B requires that a reporting entity identify which activities most significantly impact the VIE’s economic performance and determine whether it has the power to direct those activities. The economic performance of the VIE is most significantly impacted by the performance of the VIE’s managed securities portfolio. Thus, the activities that most significantly impact the VIE’s economic performance are the activities that significantly impact the performance of the managed securities portfolio.

55-205S The general partner manages the operations of the VIE. Specifically, the general partner establishes the terms of the VIE, approves the assets to be purchased and sold by the VIE, and administers the VIE by monitoring the assets and ensuring compliance with the VIE’s investment policies. The fact that the general partner was significantly involved with the creation of the VIE does not, in isolation, result in the general partner being the primary beneficiary of the VIE. However, the fact that the general partner was involved with the creation of the VIE may indicate that the general partner had the opportunity and the incentive to establish arrangements that result in the general partner being the variable interest holder with the power to direct the activities that most significantly impact the VIE’s economic performance.

55-205T The limited partners of the VIE have no voting rights and no other rights that provide them with the power to direct the activities that most significantly impact the VIE’s economic performance.

55-205U If a reporting entity has the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance, then under the requirements of paragraph 810-10-25-38A, that reporting entity also is required to determine whether it has the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE. The annual and performance-based fees paid to the general partner are both of the following:

(a) Compensation for services provided and commensurate with the level of effort required to provide those services

(b) Part of a compensation arrangement that includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm’s length.

Therefore, the annual and performance-based fees meet the criteria in paragraph 810-10-25-38H and should not be considered for purposes of evaluating the characteristic in paragraph 810-10-25-38A(b). Additionally, the general partner, through its investment in the fund, has the obligation to absorb losses of the VIE that could potentially be significant to the VIE and the right to receive benefits from the VIE that could potentially be significant to the VIE.
On the basis of the specific facts and circumstances presented in this Case and the analysis performed, the general partner would be the primary beneficiary of the VIE because:

(a) It is the variable interest holder with the power to direct the activities of the VIE that most significantly impact the VIE’s economic performance

(b) Through its investment in the fund, it has the obligation to absorb losses of the VIE that could potentially be significant to the VIE and the right to receive benefits from the VIE that could potentially be significant to the VIE.

Case K: Investment Fund 2—Annual and Performance-Based Fees and No Additional Interests

A fund manager (general partner) creates and sells partnership interests in an investment fund (limited partnership) to external investors (limited partners). The partnership interests were marketed to the investors as an opportunity to generate significant returns by allowing the general partner to have discretion to determine how to invest the fund’s assets provided that the investments are consistent with the defined parameters and objectives set forth in the limited partnership agreement. None of the limited partners are related parties of the general partner. The general partner does not hold any interests in the fund, and the general partner is not liable for any losses in the fund. Several employees of the general partner have interests in the fund. These employees chose to purchase interests in the fund and financed the purchases themselves.

The annual and performance-based fees paid to the general partner are both of the following:

(a) Compensation for services provided and commensurate with the level of effort required to provide those services

(b) Part of a service arrangement that includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm’s length.

Additionally, the general partner has no related parties with interests in the fund that individually, or in the aggregate, would absorb more than an insignificant amount of the fund’s expected losses or receive more than an insignificant amount of the fund’s expected residual returns. For purposes of this assessment, the general partner did not include its employees’ interests in the fund because the general partner did not finance those interests; therefore, the general partner has neither a direct nor an indirect economic interest in the fund. The general partner’s annual and performance-based fees do not represent a variable interest on the basis of a consideration of the conditions in paragraphs 810-10-55-37 through 55-38.

On the basis of the specific facts and circumstances presented in this Case and the analysis performed, the general partner does not have a variable
interest in the fund. The general partner has no further consolidation analysis to perform.

**Case L: eCommerce Entity**

55-205Z Company B, an affiliate of Company A, owns certain intellectual property related to eCommerce activities. Company A establishes a VIE to which Company A provides an exclusive services and asset licensing agreement. The VIE obtains access to the intellectual property owned by Company B. Company A agrees to provide strategic and technical services to the VIE and contracts with Company B to perform these services. Company B, Company A, and the VIE share the same senior management.

55-205AA Because of regulatory restrictions, Company A and its investors are precluded from owning equity in the VIE. The VIE is domiciled in a different country, which prohibits foreign investment through equity.

55-205AB The equity investors in the VIE, who are the senior management of Company A, have rights that are limited to only administrative matters.

55-205AC Company A’s compensation for the services and asset licensing agreement is the net income of the VIE, but not the VIE’s net losses. The fees paid to Company A are both of the following:

   (a) Compensation for services provided but not commensurate with the level of effort required to provide those services

   (b) Part of a service arrangement that does not include only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm’s length.

55-205AD To evaluate the facts and circumstances and determine which reporting entity, if any, is the primary beneficiary of a VIE, paragraph 810-10-25-38A requires that a reporting entity determine the purpose and design of the VIE, including the risks that the VIE was designed to create and pass through to its variable interest holders. In making this assessment, the variable interest holders of the VIE determined the following:

   (a) The primary purpose for the creation of the VIE was to bypass foreign investment restrictions and enable foreign investors (through their ownership of Company A) to participate indirectly in restricted sectors in which Company B operates through a series of contractual arrangements.

   (b) Company A will receive all of the net income but none of the net losses of the VIE.

   (c) The equity investors, the senior management of Company A, are exposed to the net losses of the VIE through their equity investments.

55-205AE Company A and the equity investors of the VIE are the variable interest holders in the VIE. The fees paid to Company A represent a variable
interest on the basis of consideration of the conditions in paragraphs 810-10-55-37 through 55-38, specifically paragraph 810-10-55-37(a) and (d).

**55-205AF** Paragraph 810-10-25-38B requires that a reporting entity identify which activities most significantly impact the VIE’s economic performance and determine whether it has the power to direct those activities. The economic performance of the VIE is significantly impacted by the performance of Company B. Company A, through its contractual arrangements, has the power to direct the activities that most significantly impact the VIE’s economic performance.

**55-205AG** The equity investors of the VIE have no voting rights and no other rights that provide them with the power to direct the activities that most significantly impact the VIE’s economic performance.

**55-205AH** If a reporting entity has the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance, then under the requirements of paragraph 810-10-25-38A, that reporting entity also is required to determine whether it has the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE. Company A, through its fee arrangements, receives benefits that could potentially be significant to the VIE. The fees paid to Company A are both of the following:

(a) Compensation for services provided but not commensurate with the level of effort required to provide those services

(b) Part of a service arrangement that does not include only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm’s length. Therefore, the fees do not meet the criteria in paragraph 810-10-25-38H, and they should be considered for purposes of paragraph 810-10-25-38A(b).

**55-205AI** On the basis of the specific facts and circumstances presented in this Case and the analysis performed, Company A would be deemed to be the primary beneficiary of the VIE because:

(a) It is the variable interest holder with the power to direct the activities of the VIE that most significantly impact the VIE’s economic performance.

(b) Through fee arrangements, it has the right to receive benefits from the VIE that could potentially be significant to the VIE.

### 6.6. RECONSIDERATION OF A VIE’S PRIMARY BENEFICIARY

**6.6.10.10.** ASC Subtopic 810-10 requires reporting enterprises to reconsider which party is the VIE’s primary beneficiary as the result of changes in facts and circumstances, as there may be situations where the party with the power to direct the activities that most significantly impact the VIE’s economic performance changes.
6.6.10.20. Examples of situations that may result in a change to an entity’s primary beneficiary status include, but are not limited to:

- Triggering of contingent events;
- Acquisition or disposition of a VIE that results in a change in control;
- Loss of rights held by the primary beneficiary (e.g., substantive kick-out or participating rights) due to the passage of time or other contractual changes; and
- Other changes in contractual agreements that affect an enterprise’s power over the VIE.

6.6.10.30. If a reporting enterprise identifies a change in a VIE’s primary beneficiary status, the reporting enterprise should determine the date on which the change occurred and recognize the accounting effect as of that date.

Question 6.6.1: Effect of a Change in Economic Performance on Primary Beneficiary Determination

Would a change in the economic performance of a VIE cause an enterprise to reevaluate whether it is the primary beneficiary of the VIE?

Interpretive Response: Perhaps. An enterprise is required to continuously reassess whether changes in facts and circumstances result in a change in the determination of whether the enterprise is the primary beneficiary of a VIE. This evaluation is not limited to the end of the reporting period. A change in economic performance of a VIE may affect the analysis of ASC subparagraph 810-10-25-38A(a) related to the activities that most significantly impact the VIE’s economic performance, particularly when the change in economics was unanticipated and affects the ongoing activities of the entity. For example, when a particular product line offered by a VIE with multiple product lines becomes much more significant to the VIE’s operating results than originally anticipated because of changes in demand for the product, changes in costs to produce the product, etc., it is possible that the activities that most significantly impact the VIE’s economic performance may change. See Question 6.2.40.1 for a more in-depth discussion of whether the activation of such contingent powers could result in a change in primary beneficiary.

It is also possible that a change in economic performance could affect the ASC subparagraph 810-10-25-38A(b) evaluation of whether a variable interest holder has the obligation to absorb losses or the right to receive benefits that could potentially be significant to the VIE. We expect this to rarely occur because the evaluation under that subparagraph encompasses all possible economic scenarios. Nevertheless, it is possible that a variable interest could be eliminated due to a VIE’s economic performance (e.g., if a tranche in an asset-backed structure is permanently written off under the terms of the trust). Further, we believe there are circumstances in which drastic and unanticipated economic activity could effectively result in a change in design of a VIE and a
reevaluation of whether a fee paid to a decision maker represents a variable interest under ASC paragraph 810-10-55-37. See Subsection 3.5 for a discussion of the reevaluation of decision-maker fees.
7. Related Parties and De Facto Agency Relationships

7.1. RELATED PARTIES

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7.2. DE FACTO AGENCY RELATIONSHIPS

7.2.10. Overview

Question 7.2.10.1: Interests Received as a Loan or Contribution from the Reporting Enterprise

7.2.20. Close Business Relationships

Question 7.2.20.1: Nature of Close Business Relationships

7.2.30. Transferability Restrictions

Question 7.2.30.1: Potential Transfer Restrictions
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7.3. EFFECT OF RELATED PARTIES ON THE PRIMARY BENEFICIARY DETERMINATION

7.3.10. Determining Which Party in a Related Party Group Should Consolidate a VIE

Question 7.3.10.1: Determining Which Party in a Related Party Group Should Consolidate a VIE
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PRINCIPAL-AGENCY RELATIONSHIP

Question 7.3.20.2: Identifying a Principal-Agency Relationship

RELATIONSHIP AND SIGNIFICANCE OF ACTIVITIES

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Question 7.3.20.3: Determining the Primary Beneficiary in a Shared Power Related Party Group
The Effect of Related Parties

25-42 Single Decision Maker—The assessment in this paragraph shall be applied only by a single reporting entity that meets the characteristic in paragraph 810-10-25-38A(a). For purposes of determining whether that single reporting entity, which is a single decision maker, is the primary beneficiary of a VIE, the single decision maker shall include its direct economic interests in the entity and its indirect economic interests in the entity held through related parties (the term related parties in this paragraph refers to all parties as defined in paragraph 810-10-25-43), considered on a proportionate basis. For example, if the single decision maker owns a 20 percent interest in a related party and that related party owns a 40 percent interest in the entity being evaluated, the single decision maker’s interest would be considered equivalent to an 8 percent direct interest in the VIE for purposes of evaluating the characteristic in paragraph 810-10-25-38A(b) (assuming it has no other relationships with the entity). Similarly, if an employee (or de facto agent) of the single decision maker owns an interest in the entity being evaluated and that employee’s (or de facto agent’s) interest has been financed by the single decision maker, the single decision maker would include that financing as its indirect interest in the evaluation. For example, if a decision maker’s employees have a 30 percent interest in the VIE and one third of that interest was financed by the decision maker, then the single decision maker’s interest would be considered equivalent to a 10 percent direct interest in the VIE. Indirect interests held through related parties that are under common control with the decision maker should be considered the equivalent of direct interests in their entirety. [This paragraph has been amended by ASU 2016-17, Interests Held through Related Parties That Are under Common Control, which becomes effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2016. For all other entities, it is effective for annual periods in fiscal years beginning after December 15, 2016, and interim periods in fiscal years beginning after December 15, 2017. See additional discussion in Question 7.3.10.1.]

PENDING CONTENT: This paragraph reflects the amendments made by ASU 2016-17, Interests Held through Related Parties That Are under Common Control, which becomes effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2016. For all other entities, it is effective for annual periods in fiscal years beginning after December 15, 2016, and interim periods in fiscal years beginning after December 15, 2017. See additional discussion in Question 7.3.10.1..

25-42 Single Decision Maker—The assessment in this paragraph shall be applied only by a single reporting entity that meets the characteristic in paragraph 810-10-25-38A(a). For purposes of determining whether that single reporting entity, which is a single
decision maker, is the primary beneficiary of a VIE, the single
decision maker shall include all of its direct variable interests in the
entity and, on a proportionate basis, its indirect variable interests in
the entity held through related parties (the term related parties in this
paragraph refers to all parties as defined in paragraph 810-10-25-
43). For example, if the single decision maker owns a 20 percent
interest in a related party and that related party owns a 40 percent
interest in the entity being evaluated, the single decision maker’s
indirect interest in the VIE held through the related party would be
equivalent to an 8 percent direct interest in the VIE for purposes of
evaluating the characteristic in paragraph 810-10-25-38A(b)
(assuming it has no other relationships with the entity). Similarly, if
an employee (or de facto agent) of the single decision maker owns
an interest in the entity being evaluated and that employee’s (or de
facto agent’s) interest has been financed by the single decision
maker, the single decision maker would include that financing as its
indirect interest in the evaluation. For example, if a single decision
maker’s employees have a 30 percent interest in the VIE and one
third of that interest was financed by the single decision maker, then
the single decision maker’s indirect interest in the VIE through the
financing would be equivalent to a 10 percent direct interest in the
VIE.

25-43 For purposes of applying the guidance in the Variable Interest Entities
Subsections, unless otherwise specified, the term related parties includes
those parties identified in Topic 850 and certain other parties that are acting as
de facto agents or de facto principals of the variable interest holder. All of the
following are considered to be de facto agents of a reporting entity:

(a) A party that cannot finance its operations without subordinated
    financial support from the reporting entity, for example, another VIE
    of which the reporting entity is the primary beneficiary

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

(c) An officer, employee, or member of the governing board of the
    reporting entity

(d) A party that has an agreement that it cannot sell, transfer, or
    encumber its interests in the VIE without the prior approval of the
    reporting entity. The right of prior approval creates a de facto agency
    relationship only if that right could constrain the other party’s ability to
    manage the economic risks or realize the economic rewards from its
    interests in a VIE through the sale, transfer, or encumbrance of those
    interests. However, a de facto agency relationship does not exist if
    both the reporting entity and the party have right of prior approval
    and the rights are based on mutually agreed terms by willing,
    independent parties.
(e) A party that has a close business relationship like the relationship between a professional service provider and one of its significant clients.

25-44 The guidance in this paragraph shall be applicable for situations in which the conditions in paragraph 810-10-25-44A have been met or when power is shared for a VIE. In situations in which a reporting entity concludes that neither it nor one of its related parties has the characteristics in paragraph 810-10-25-38A but, as a group, the reporting entity and its related parties (including the de facto agents described in paragraph 810-10-25-43) have those characteristics, then the party within the related party group that is most closely associated with the VIE is the primary beneficiary. The determination of which party within the related party group is most closely associated with the VIE requires judgment and shall be based on an analysis of all relevant facts and circumstances, including all of the following:

(a) The existence of a principal-agency relationship between parties within the related party group
(b) The relationship and significance of the activities of the VIE to the various parties within the related party group
(c) A party’s exposure to the variability associated with the anticipated economic performance of the VIE
(d) The design of the VIE.

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

25-44B This paragraph applies to a related party group that has the characteristics in paragraph 810-10-25-38A only when both of the following criteria are met. This paragraph is not applicable for legal entities that meet the conditions in paragraphs 323-740-15-3 and 323-740-25-1.

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

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

**Excerpt from ASC Subsection 850-10-20**

**Related Parties**

Related parties include:

(a) Affiliates of the entity

(b) Entities for which investments in their equity securities would be required, absent the election of the fair value option under the Fair Value Option Subsection of Section 825–10–15, to be accounted for by the equity method by the investing entity

(c) Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management

(d) Principal owners of the entity and members of their immediate families

(e) Management of the entity and members of their immediate families

(f) Other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests

(g) Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

**7.1. RELATED PARTIES**

**7.1.10.10.** One of the significant ways in which the VIE consolidation guidance in ASC Subtopic 810-10, *Consolidation – Overall*, differs from the voting interest entity consolidation guidance is that it requires a reporting enterprise that holds a variable interest in a VIE to consider whether its related parties also hold a variable interest in the VIE when evaluating whether the reporting enterprise is required to consolidate the VIE. The related party guidance in the VIE subsections of ASC Subtopic 810-10 was designed to ensure that an enterprise could not avoid the VIE consolidation requirements by entering into transactions with its related parties that are structured so that no individual party would be the VIE's primary beneficiary. To prevent that outcome, the FASB initially decided,
before issuing FASB Accounting Standards Update No. 2015-02 (ASU 2015-02), *Amendments to the Consolidation Analysis*, to require the interests of related parties to be considered in the aggregate to determine the primary beneficiary of a VIE. When deliberating the guidance in ASU 2015-02, the primary objective of the Board was to address concerns expressed by financial statement users about the possibility that the consolidation guidance introduced in FASB Accounting Standards Update No. 2009-17 (ASU 2009-17), *Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities* (originally issued as FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)* (Statement 167)), could require investment managers and similar entities to consolidate certain investment funds that they manage. The FASB ultimately decided that it could achieve this objective by reducing the likelihood that a decision maker or service provider would meet the definition of a primary beneficiary by changing (1) the evaluation of whether fees paid to a decision maker or service provider are a variable interest and how fees are considered when making the primary beneficiary determination to the extent such fees represent a variable interest (See Subsection 3.5 and Section 4, *Variable Interest Entity Determination and Reconsideration*), and (2) the related party guidance (addressed in this section).

**7.1.10.20.** Related parties, for purposes of ASC Subtopic 810-10, include those contemplated in ASC Topic 850, *Related Party Disclosures*, and certain parties that act as de facto agents or principals of the reporting enterprise. Identifying an enterprise’s related parties is important if those parties hold a variable interest in a VIE in which the enterprise also holds a variable interest. This is because the enterprise may reach a different conclusion about whether it is the VIE’s primary beneficiary when variable interests in that same VIE are held by its related parties than it would when considering only its own interest(s) in the VIE.

**Question 7.1.1: Related Party Considerations When the Reporting Enterprise Does Not Hold a Variable Interest in a VIE**

Must a reporting enterprise that does not hold a variable interest in a VIE apply the guidance in ASC paragraphs 810-10-25-42 through 25-44B (i.e., consider variable interests held by its related parties)?

**Interpretive Response:** No. ASC paragraph 810-10-25-42 states that it “…shall be applied only by a single reporting entity that meets the characteristic in paragraph 810-10-25-38A(a).” As discussed in Question 6.3.30.4, once a decision maker determines that its fee meets the conditions in ASC paragraphs 810-10-55-37 and 55-38 (i.e., to not be a variable interest), the decision maker would not need to continue with its VIE consolidation analysis. In other words, the decision maker would not need to determine whether it meets the conditions described in subparagraphs 810-10-25-38A(a) and 25-38A(b) to be the primary beneficiary of a VIE. Accordingly, we believe reporting enterprises that do not hold a variable interest in a VIE are not required to apply the guidance in ASC paragraphs 810-10-25-42 through 25-44B. However, reporting enterprises should carefully consider whether any
explicit or implicit arrangements represent a variable interest before concluding that the guidance in ASC paragraphs 810-10-25-42 through 25-44B does not apply.

7.2. DE FACTO AGENCY RELATIONSHIPS

7.2.10. Overview

7.2.10.10. To prevent enterprises from avoiding the VIE consolidation requirements of ASC Subtopic 810-10, the FASB expanded the definition of related parties for purposes of applying this guidance beyond the definition in ASC Subtopic 850-10, Related Party Disclosures - Overall. The expanded list of related parties are referred to as de facto agents or principals. Determining whether an entity is a de facto agent or principal often will require a significant level of professional judgment.

**Question 7.2.10.1: Interests Received as a Loan or Contribution from the Reporting Enterprise**

ASC subparagraph 810-10-25-43(b) indicates that “A party that received its interests as a contribution or a loan from the reporting entity” is considered to be a de facto agent of the reporting enterprise. Would a party be considered a de facto agent of a reporting enterprise if it only received a portion (i.e., less than 100%) of its interests in the VIE through a loan or contribution from the reporting enterprise?

**Interpretive Response:** Yes. We believe that a de facto agency relationship is created regardless of whether the loan or contribution from the reporting enterprise provided the party with all or a portion of its interests in a VIE. See the guidance beginning at paragraph 7.3.10.10 for how interests of related parties and de facto agents are considered in the primary beneficiary determination.

7.2.10.20. We also understand that the SEC staff has indicated informally that the guidance in ASC Subtopic 470-50, Debt - Modifications and Extinguishments, and ASC Topic 606, Revenue from Contracts with Customers, provides reporting enterprises with additional factors to consider when evaluating whether a de facto agency relationship exists. Note that under the guidance in ASC paragraphs 810-10-25-42 through 25-44B, determining whether a reporting enterprise is a de facto agent of another party is only necessary and relevant to the analysis of whether the reporting enterprise should consolidate a VIE if the other party holds an explicit or implicit variable interest in the VIE. For example, a reporting enterprise would not be able to conclude that it is not the primary beneficiary of a VIE (or, alternatively, be required to conclude that it is the primary beneficiary of a VIE) solely because it is a de facto agent of another party that is not a variable interest holder in the VIE.
7.2.20. Close Business Relationships

7.2.20.10. ASC subparagraph 810-10-25-43(e) states that having a close business relationship may create a de facto agency relationship. This provision was included to avoid structuring opportunities that might otherwise exist if third-party service providers were excluded from the consolidation analysis. In practice, it often will be very difficult to ascertain which parties represent a close business relationship to the evaluating enterprise. However, relationships that an enterprise has with service providers such as attorneys and investment bankers, and other parties that facilitate the enterprise’s involvement with the VIE in question may represent a close business relationship under ASC subparagraph 810-10-25-43(e).

Question 7.2.20.1: Nature of Close Business Relationships

What should be considered a close business relationship when evaluating whether a de facto agency relationship exists under ASC subparagraph 810-10-25-43(e)?

Interpretive Response: We understand that close business relationships are those between a reporting enterprise and its professional service providers, such as investment bankers, accountants, lawyers, and others that have had a significant level of involvement in structuring an entity or a transaction. Reporting enterprises should carefully evaluate their level of involvement with third-party professional service providers and understand whether the VIE is a significant client to the service provider, which may indicate a de facto agency relationship exists. This requires a critical evaluation of the specific facts and circumstances surrounding the enterprise’s involvement with the VIE.

In a speech at the 2008 AICPA National Conference on Current SEC and PCAOB Developments, a member of the SEC staff commented on the staff’s views about what constitutes a close business relationship in the context of the ASC subparagraph 810-10-15-14(c) disproportionality criterion for determining whether an entity is a VIE. An excerpt from the speech follows:

Excerpt from Speech by Robert B. Malhotra

In the context of [ASC paragraph 810-10-15-14(c)], the staff has been asked whether certain close business associates may be considered related parties under [ASC Topic 850] or [ASC paragraph 810-10-25-43]. In this context, the staff believes that close business associates may only be considered related parties if one party can control or can significantly influence the other party to an extent that one of the parties might be prevented from fully pursuing their own separate interest should that party choose to do so. That being the case, the mere past practice or future intent of close business associates to collaborate would be insufficient to conclude the parties are related. The staff believes that this is consistent with the definition of a related party included in [ASC Subsection 810-10-20].
We understand the SEC staff’s views may not apply to evaluations of whether a relationship represents a close business relationship outside the context of ASC subparagraph 810-10-15-14(c).

7.2.30. Transferability Restrictions

7.2.30.10. ASC subparagraph 810-10-25-43(d) indicates that a de facto agent related party relationship exists when a party agrees not to sell, transfer, or encumber its interests in the VIE without the prior approval of the enterprise. Agreements that involve those restrictions may arise in certain operating entities such as partnerships and joint ventures, and in franchise arrangements.

7.2.30.20. The FASB included guidance in ASU 2009-17 that substantive mutual transfer restrictions based on agreed-on terms by willing, independent parties do not cause those parties to be de facto agents of each other. The Board emphasized that a conclusion that a related party relationship does not exist under ASC paragraphs 810-10-25-42 and 25-43 does not eliminate the need for each party with a variable interest to determine whether it is the primary beneficiary of a VIE under the requirements in ASC paragraph 810-10-25-38.¹

7.2.30.30. ASC subparagraph 810-10-25-43(d) also indicates that the right of prior approval does not create a de facto agency relationship if that right does not constrain the restricted party’s ability to manage the economic risks or realize the economic rewards from its interests in the VIE through the sale, transfer, or encumbrance of those interests. We understand that the FASB intended this guidance in ASC subparagraph 810-10-25-43(d) to be interpreted similarly to the guidance in ASC Topic 860, Transfers and Servicing, about the ability of a transferee to pledge or exchange transferred financial assets. Accordingly, a de facto agency relationship presumptively is not created under ASC subparagraph 810-10-25-43(d) if a party has the ability to realize the economic benefits of its interest by obtaining substantially all of the cash flows from its interest without the enterprise’s approval. The notion of substantially all has been interpreted under ASC Topic 860 to mean 90% or more. Paragraph D43 of the Basis for Conclusions to FIN 46(R) indicates that if the right of prior approval is designed solely to prevent transfer of the interest to a competitor or to a less creditworthy, or otherwise less qualified holder, and those parties are not the only potential purchasers of the interest, the right would not create a de facto agency relationship.² Although FIN 46(R) is now superseded, we believe that the FASB’s intent has not changed and that what is described in paragraph D43 is still relevant. We believe that the contractual provisions of the arrangement need to provide objective criteria to evaluate whether the other party is less creditworthy or otherwise less qualified to support such a conclusion. The FASB chose not to

¹ Paragraph A70 of Statement 167.
² FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities.
include the guidance in ASC Topic 860 that the right of prior approval does not represent a constraint if there is a contractual requirement that the approval of the restricting enterprise is not to be unreasonably withheld. Consequently, determining whether a restriction on transfer, sale, or encumbrance of a party’s interest represents a constraint will depend on the specific facts and circumstances. In that respect, the meaning of the term transfer may include sales (as it does in ASC Topic 860) and, if so, a requirement for a party to obtain the enterprise’s approval to transfer or encumber its interest likely would create a de facto related party relationship.

7.2.30.40. If a reporting enterprise and another party are de facto related parties solely due to transferability restrictions and the reporting enterprise has no economic interest in the other party, ASU 2015-02 provides that the de facto related party’s interest would not be considered by the reporting enterprise when evaluating the conditions in ASC subparagraphs 810-10-55-37(c) and 810-10-25-38A(b). See Question 7.3.10.1 for further details.

**Question 7.2.30.1: Potential Transfer Restrictions**

How should the phrase *without the prior approval of the reporting entity* in ASC subparagraph 810-10-25-43(d) be evaluated when determining whether a contractual arrangement creates a de facto agency relationship?

**Interpretive Response:** It depends on which contractual provisions the phrase *without the prior approval of the reporting entity* applies to. Following are some common approval provisions and a discussion of whether they may give rise to a de facto agency relationship.

*Right of first refusal.* A right of first refusal grants the holder with the opportunity to accept an offer before that offer is accepted by another party. For instance, the co-owners of a joint venture may each hold a right that requires the selling party to present the non-selling party with the option of purchasing the selling party’s interest for the same price and terms that were agreed to with a third-party before selling to that third-party. Because this type of right would not restrict the variable interest holder’s ability to sell or transfer its interest (i.e., it only provides the holder with an opportunity to meet the terms of an existing offer), we believe that it does not create a de facto agency relationship.

*Right of first offer.* A right of first offer grants the holder with the opportunity to receive an offer before that offer is made available to another party. The holder then has the option of accepting or rejecting the terms of the offer. If the holder rejects the terms, it is considered to have provided its consent for a proposed sale at a price equivalent to or greater than those in the original offer (i.e., the reporting enterprise may not sell its interest at any price or terms that are less favorable than those included in the original offer). While the right of first offer may provide some limitations over which party the reporting enterprise can sell its interest to, we believe that it does not create a de facto agency relationship.
because it does not restrict the variable interest holder’s ability to sell or transfer its interest.

Approval not to be unreasonably withheld or delayed. In certain situations, a variable interest holder may have an agreement that it cannot sell, transfer, or encumber its interests in the entity without the prior approval of another party, and this approval is not to be unreasonably withheld or delayed. Because another entity has the ability to restrict the variable interest holder’s ability to sell or transfer its interest, we believe that the evaluation of whether a de facto agency relationship exists will depend on a more in-depth analysis of the circumstances in which the other entity could withhold its approval. Reporting enterprises should consider all relevant facts and circumstances, including the fact that approval is not to be unreasonably withheld, when making this determination.

**Question 7.2.30.2: Mutual Transfer Restrictions**

Would an agreement that a reporting enterprise cannot sell, transfer, or encumber its interests in an entity without the prior approval of another party result in a de facto agency relationship if the reporting enterprise has the same approval rights with respect to actions of the other party (i.e., if the agreement is mutual)?

**Interpretive Response:** No. A de facto agency relationship does not exist if both parties have an agreement that they cannot sell, transfer, or encumber the other party’s interests without approval as long as the rights are based on agreed-on terms by willing, independent parties.

**Question 7.2.30.3: Limited Transferability Restrictions**

How should the guidance in ASC subparagraph 810-10-25-43(d) be applied by the reporting enterprise if an agreement exists that restricts a party’s ability with respect to only one of the activities specified in that paragraph (i.e., restriction on one of the following: selling, transferring, or encumbering its interests)?

**Interpretive Response:** We believe that a de facto agency relationship would not exist if the party would have the ability to realize the economic rewards from its interests in the VIE by either selling, transferring, or encumbering those interests. For example, if a party was restricted from encumbering its interests in a VIE, but was permitted to sell or transfer those interests to realize its economic benefits, a de facto agency relationship would not exist.

Reporting enterprises should evaluate all facts and circumstances when determining whether restrictions on selling, transferring, or encumbering an interest creates a de facto agency relationship. For example, an enterprise may attempt to avoid creating a de facto agency relationship by structuring an
arrangement with a party that only prohibits it from encumbering its interest (but not from selling or transferring it), knowing that the party is already prohibited from selling or transferring its interest because of regulatory reasons. A de facto agency relationship likely would exist in this situation because of the other restrictions that were not imposed by the enterprise together with the restriction that was imposed by the enterprise.

Question 7.2.30.4: Managing Economic Risks and Rewards through a Hedging Relationship

If a party that is restricted from selling, transferring, or encumbering its interest in a VIE can manage the economic risks and realize the economic rewards of its interest by entering into a derivative instrument that serves as a hedge of its interest, would that fact alone permit the restricted party to conclude that the restriction does not result in a constraint that creates a de facto agency relationship under the guidance in ASC subparagraph 810-10-25-43(d)?

Interpretive Response: No. The FASB indicated in paragraph D44 of the Basis for Conclusions to FIN 46(R) that a party’s ability to hedge its interest in a VIE does not, in and of itself, result in a conclusion that the restriction does not create a constraint. Although FIN 46(R) is now superseded, we believe that the FASB’s intent has not changed and that what is described in paragraph D44 is still relevant.

7.3. EFFECT OF RELATED PARTIES ON THE PRIMARY BENEFICIARY DETERMINATION

7.3.10. Determining Which Party in a Related Party Group Should Consolidate a VIE

7.3.10.10. A reporting enterprise that is a related party of one or more other variable interest holders of a VIE is required to evaluate first whether it individually meets the conditions in ASC paragraph 810-10-25-38A to be deemed the VIE’s primary beneficiary. That is, the reporting enterprise must determine whether it has (a) the power to direct the activities that most significantly impact the VIE’s economic performance and (b) the obligation to absorb losses of the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE. A reporting enterprise that is the single decision maker of a VIE (i.e., the reporting enterprise meets the characteristic in ASC subparagraph 810-10-25-38A(a)) must include its direct economic interests and indirect interests held through related parties (including de facto agents) in the VIE in determining whether it meets the characteristic in ASC subparagraph 810-10-25-38A(b) to be considered the primary beneficiary.

7.3.10.20. If a reporting enterprise determines that it individually meets the characteristics necessary to be deemed the VIE’s primary beneficiary, then no
further evaluation of related parties or de facto agents of the reporting enterprise is required. However, when no variable interest holder in a related party group individually meets the characteristics to be considered the primary beneficiary of a VIE, other considerations apply to determine which party, if any, in a related party group that collectively meets those characteristics is considered the VIE’s primary beneficiary. Examples of situations where a related party group collectively meets the requirements of ASC paragraph 810-10-25-38A include, but are not limited to:

- One member of the related party group is the decision maker (i.e., has the power to direct the activities that most significantly impact the VIE’s economic performance under ASC subparagraph 810-10-25-38A(a)), but does not have the obligation to absorb losses or right to receive benefits that could potentially be significant to the VIE (ASC subparagraph 810-10-25-38A(b)). However, when considered collectively, the related party group meets the criterion in ASC subparagraph 810-10-25-38A(b)).

- Multiple related parties direct the activities that most significantly impact the economic performance of the VIE, and the nature of the activities that each party is directing is the same but no party individually has power over a majority of these activities. The related party group collectively meets the conditions in ASC paragraph 810-10-25-38A.

**Question 7.3.10.1: Determining Which Party in a Related Party Group Should Consolidate a VIE**

How should a reporting enterprise evaluate which party, if any, in a related party group that collectively meets the criteria to be a VIE’s primary beneficiary, should consolidate the VIE when none of the parties individually meets the criteria to be the primary beneficiary?

**Interpretive Response:** To determine whether it individually meets the criteria to be the primary beneficiary of a VIE, a single decision maker is required to consider its direct variable interests and indirect interests held through related parties in evaluating the potentially significant variable interest primary beneficiary criterion. The following decision tree describes the effect of related parties on the evaluation of whether the decision maker individually meets the primary beneficiary criteria.
See Subsection 3.5 for guidance about how a decision maker should consider interests in a VIE held by related parties when evaluating whether its fee is a variable interest in the VIE.

In October 2016, the FASB changed the guidance about how a single decision maker should consider indirect interests held by related parties that are under common control. Currently, ASC paragraph 810-10-25-42 (as shown above) requires the single decision maker to consider interests held by related parties that are under common control in their entirety when evaluating whether it has a potentially significant variable interest. ASU 2016-17 requires the single decision maker to consider indirect interests held through related parties that...
are under common control on a proportionate basis. This change will result in the single decision maker considering all indirect interests held through related parties on a proportionate basis regardless of whether it is under common control with the related party.

The ASU is effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2016. For all other entities, it is effective for annual periods in fiscal years beginning after December 15, 2016, and interim periods in fiscal years beginning after December 15, 2017. Entities that have not adopted ASU 2015-02 should adopt ASU 2016-17 at the same time and apply the same transition method for both standards. Entities that already adopted ASU 2015-02 should apply ASU 2016-17 retrospectively to all periods beginning with the earliest annual period in which they adopted ASU 2015-02. Entities can adopt ASU 2016-17 immediately, including in an interim period. However, if an entity adopts the ASU in an interim period other than the first interim period of its fiscal year, it should compute and reflect the cumulative effect of the accounting change as of the beginning of the fiscal year that includes that interim period.

When no variable interest holder individually meets the criteria to be considered the primary beneficiary of a VIE, other considerations apply to determine which party, if any, in a related party group that collectively meets those criteria is considered the VIE’s primary beneficiary. The following decision tree and table describe ASU 2015-02’s provisions about how a reporting enterprise should determine which party, if any, in a related party group should consolidate a VIE.
Primary Beneficiary Identification in a Related Party Group - ASU’s Stated Provisions

- Does a single variable interest holder meet the primary beneficiary (PB) criteria?
  - Yes: The variable interest holder is the PB and consolidates the VIE.
  - No:
    - Is there shared power and a group of related parties that collectively meets the PB criteria?
      - Yes: Stop consolidation analysis - the VIE does not have a PB.
      - No:
        - Does the VIE have a single decision maker?
          - Yes: Perform the related party identification test in ASC 810-10-25-41 to determine which party in the related party group is most closely associated with, and should consolidate, the VIE.
          - No: Stop consolidation analysis - the VIE does not have a PB.

- Is the single decision maker of a variable interest (even though the decision maker does not meet the PB criteria)?
  - Yes: Stop consolidation analysis - the VIE does not have a PB.
  - No:
    - Is the single decision maker part of a related party group that collectively meets the PB criteria?
      - Yes: Stop consolidation analysis - the VIE does not have a PB.
      - No:
        - Are all of the VIE’s activities conducted on behalf of a variable interest holder that is a variable interest entity of the single decision maker?
          - Yes: Stop consolidation analysis - the VIE does not have a PB.
          - No: Stop consolidation analysis - the VIE does not have a PB.
## ASU 2015-02’s Provisions When Decision Maker Does Not Individually Meet the Primary Beneficiary Criteria

<table>
<thead>
<tr>
<th>Situation</th>
<th>Primary Beneficiary Determination</th>
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<tbody>
<tr>
<td>There is shared power and a group of related parties collectively meets the criteria to be considered the VIE’s primary beneficiary</td>
<td>Perform the related party tiebreaker test in ASC paragraph 810-10-25-44 to determine which party in the related party group is most closely associated with, and should consolidate, the VIE. See paragraph 7.3.20.10 for further discussion of the related party tiebreaker test.</td>
</tr>
<tr>
<td>A single decision maker is part of a group of related parties under common control that collectively meets the criteria to be considered the VIE’s primary beneficiary, and the single decision maker’s fee is a variable interest</td>
<td></td>
</tr>
<tr>
<td>There is a single decision maker, the single decision maker’s fee is a variable interest, the single decision maker is not part of a group of related parties under common control that collectively meets the criteria to be considered the VIE’s primary beneficiary, and substantially all of the VIE’s activities either involve or are conducted on behalf of another variable interest holder in the related party group</td>
<td>The party for which substantially all of the VIE’s activities either involve or are conducted (excluding the single decision maker) is the primary beneficiary and consolidates the VIE.</td>
</tr>
<tr>
<td>There is a single decision maker, the single decision maker’s fee is a variable interest, the single decision maker is part of a group of related parties that collectively meets the criteria to be considered the VIE’s primary beneficiary, and substantially all of the VIE’s activities either involve or are conducted on behalf of another variable interest holder in the related party group</td>
<td></td>
</tr>
<tr>
<td><strong>Consolidation of Variable Interest Entities, Section 7</strong></td>
<td><strong>422</strong></td>
</tr>
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</tr>
<tr>
<td><strong>• The single decision maker’s fee is not a variable interest, and</strong></td>
<td><strong>• The single decision maker’s fee is not a variable interest, and</strong></td>
</tr>
<tr>
<td><strong>• Substantially all of the VIE’s activities either involve or are conducted on behalf of another variable interest holder in the related party group</strong></td>
<td><strong>• Substantially all of the VIE’s activities either involve or are conducted on behalf of another variable interest holder in the related party group</strong></td>
</tr>
<tr>
<td><strong>OR</strong></td>
<td><strong>OR</strong></td>
</tr>
<tr>
<td><strong>• There is no group of related parties that collectively meets the criteria to be considered the VIE’s primary beneficiary</strong></td>
<td><strong>• There is no group of related parties that collectively meets the criteria to be considered the VIE’s primary beneficiary</strong></td>
</tr>
<tr>
<td><strong>OR</strong></td>
<td><strong>OR</strong></td>
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<tr>
<td><strong>• There is not shared power, and</strong></td>
<td><strong>• There is not shared power, and</strong></td>
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<tr>
<td><strong>• There is not a single decision maker</strong></td>
<td><strong>• There is not a single decision maker</strong></td>
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<td><strong>OR</strong></td>
<td><strong>OR</strong></td>
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<tr>
<td><strong>• There is a single decision maker, and</strong></td>
<td><strong>• There is a single decision maker, and</strong></td>
</tr>
<tr>
<td><strong>• The decision maker is not part of a group of related parties that collectively meets the criteria to be considered the VIE’s primary beneficiary</strong></td>
<td><strong>• The decision maker is not part of a group of related parties that collectively meets the criteria to be considered the VIE’s primary beneficiary</strong></td>
</tr>
<tr>
<td><strong>OR</strong></td>
<td><strong>OR</strong></td>
</tr>
<tr>
<td><strong>• There is a single decision maker, and</strong></td>
<td><strong>• There is a single decision maker, and</strong></td>
</tr>
<tr>
<td><strong>• The single decision maker is not part of a group of related parties under common control that collectively meets the criteria to be considered the VIE’s primary beneficiary, and</strong></td>
<td><strong>• The single decision maker is not part of a group of related parties under common control that collectively meets the criteria to be considered the VIE’s primary beneficiary, and</strong></td>
</tr>
<tr>
<td><strong>• Substantially all of the VIE’s activities do not involve and are not conducted on behalf of another variable interest holder in a related-party group that includes the decision maker and collectively meets the criteria to be considered the VIE’s primary beneficiary</strong></td>
<td><strong>• Substantially all of the VIE’s activities do not involve and are not conducted on behalf of another variable interest holder in a related-party group that includes the decision maker and collectively meets the criteria to be considered the VIE’s primary beneficiary</strong></td>
</tr>
<tr>
<td><strong>Stop consolidation analysis – related party tiebreaker test is not performed and none of the variable interest holders consolidates the VIE.</strong></td>
<td><strong>Stop consolidation analysis – related party tiebreaker test is not performed and none of the variable interest holders consolidates the VIE.</strong></td>
</tr>
</tbody>
</table>
We believe an entity’s evaluation of whether substantially all of the VIE’s activities either involve or are conducted on behalf of a variable interest holder in a related party group should be consistent with this same evaluation performed when an entity has disproportionately few voting rights, as required by ASC subparagraph 810-10-15-14(c)(2) for purposes of determining whether the entity is a VIE. See Question 4.2.80.2 for considerations that we believe should be included in the analysis.

Example 7.3.10.1: Determining the Primary Beneficiary in a Common Control Group When the Single Decision Maker’s Fee Is Not a Variable Interest

A general partner holds a 2% equity interest in a limited partnership that is a VIE, and its decision maker fee is embedded in its equity interest. Assume that the general partner's fee does not represent a variable interest (i.e., the conditions in ASC paragraph 810-10-55-37 have been met). One limited partner holds a 98% limited partnership interest. That limited partner lacks substantive participating rights or kick-out rights. The general partner and limited partner are under common control, but neither holds an interest in the other.

General Partner Analysis
The general partner should not consolidate the VIE if its decision maker fee is not a variable interest. When the fee is not a variable interest, the general partner is deemed to be acting in a fiduciary capacity; therefore, the general partner does not meet the power criterion and cannot consolidate the limited partnership.

The fact that the limited partner is under common control with the general partner does not change the general partner's consolidation conclusion. Because the general partner does not meet the power criterion, it should not perform the related party tiebreaker test in ASC paragraph 810-10-25-44. The related party tiebreaker test applies only when a single decision maker concludes, after performing the assessment in ASC paragraph 810-10-25-42, that it does not individually meet both of the criteria to be the primary beneficiary. However, the assessment in ASC paragraph 810-10-25-42 applies only if the general partner meets the power criterion in ASC paragraph 810-10-25-38A(a). The general partner in this example does not meet the power criterion because it does not have a variable interest.

Limited Partner Analysis
Generally, a limited partner should not consolidate a limited partnership that is a VIE if it does not meet the power criterion, unless it is required to do so under the related party primary beneficiary requirements. In this situation, although the limited partner has an obligation to absorb losses and the right to receive benefits from the limited partnership that could potentially be significant, the
limited partner lacks the power to direct the activities that most significantly impact the limited partnership’s economic performance.

Because the general partner's fee is not a variable interest, the limited partner should not perform the related party tiebreaker test. However, because the general partner and limited partner are related parties, the limited partner should consolidate the limited partnership if substantially all of the limited partnership's activities either involve or are conducted on its behalf (unless the limited partner is an investor in a low-income housing tax credit structure, see Question 7.3.10.4).

**Parent Company Analysis**

The parent company of the general and limited partners would be required to consolidate the limited partnership in its consolidated financial statements because it meets both the power and potentially significant variable interest criteria in ASC paragraph 810-10-25-38A. This is the case even if neither the general partner nor the limited partner would individually be considered the primary beneficiary of the limited partnership for their separate company reporting.

**Example 7.3.10.2: Entity Controlled by Voting Interests**

A VIE issues beneficial interests that carry substantive voting rights but are not considered equity under U.S. GAAP. Three related parties (D, E, and F) hold 25%, 35%, and 40%, respectively, of the voting interests. Decisions about the activities that most significantly impact the VIE’s economic performance require a simple majority vote of the voting interests. Consequently, two of the three parties must agree on all of the decisions that most significantly impact the VIE’s economic performance.

None of the parties individually meets the criteria to be the VIE’s primary beneficiary, but as a group, they meet the primary beneficiary criteria. However, as discussed above, in this example the related party primary beneficiary guidance would not apply because there is not a single decision maker and there is not shared power (see additional discussion in Question 7.3.10.2). Consequently, the VIE would not be consolidated by any of the variable interest holders. Note that this conclusion does not depend on the nature of the related party relationship (e.g., whether the parties are under common control).
Example 7.3.10.3: Indirect Interests in a VIE Held Through Related Parties and De Facto Agents of a Single Decision Maker

Scenario 1

A VIE is created to hold a portfolio of asset-backed securities and is financed with multiple classes of debt and nominal equity. Bank A is the asset manager of the VIE and for its services, earns base, fixed-senior and subordinated fees, and a performance-based fee in which it receives a portion of the VIE’s profits above a targeted return. The fees are considered commensurate with the services provided and only include customary terms and conditions. Bank A has the power to direct the activities that most significantly impact the VIE’s economic performance. The VIE’s other variable interest holders lack the right to remove Bank A as the asset manager without cause and lack any other rights to participate in the decisions about the VIE’s activities.

Bank A holds 4% of each class of the VIE’s debt and equity. Bank A’s related party B (which is controlled by Bank A’s parent company) holds a 1% interest in each class of the VIE’s debt and equity. Bank A owns 0.5% of party B’s equity. Bank A’s CEO holds 0.2% of each class of the VIE’s debt and equity. Bank A provided a loan to its CEO for half of the CEO’s investment. Bank A’s related party C holds a 50% interest in each class of the VIE’s debt and equity. Bank A owns 20% of party C’s equity.

In determining whether its fees are a variable interest and in determining whether it meets the potentially significant variable interest primary beneficiary criterion and therefore is the VIE’s primary beneficiary, Bank A includes the following interests:

- Its 4% direct interest in the VIE;
- Party B’s 1% interest in the VIE in its entirety;
• Half of its CEO’s 0.2% interest; and
• 20% of Party C’s 50% interest.

As a result, Bank A’s fees would be considered a variable interest and Bank A would be the VIE’s primary beneficiary. (This is true even though Bank A’s fees are excluded from the determination of whether it meets the potentially significant variable interest primary beneficiary criterion.)

There is no related party primary beneficiary analysis because Bank A meets the criteria to be the primary beneficiary on the basis of its decision-making rights together with its direct variable interests and indirect variable interests held through related parties.

In October 2016, the FASB changed the guidance about how a single decision maker should consider indirect interests held by related parties that are under common control. Currently, ASC paragraph 810-10-25-42 requires the single decision maker to consider interests held by related parties that are under common control in their entirety when evaluating whether it has a potentially significant variable interest. ASU 2016-17 requires the single decision maker to consider indirect interests held through related parties that are under common control on a proportionate basis. This change results in the single decision maker considering all indirect interests held through related parties on a proportionate basis regardless of whether it is under common control with the related party. Under ASU 2016-17, Bank A will include only 0.5% of Party B’s 1% interest in the VIE when it evaluates the potentially significant variable interest criterion.

ASU 2016-17 is effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2016. For all other entities, it is effective for annual periods in fiscal years beginning after December 15, 2016, and interim periods in fiscal years beginning after December 15, 2017. Entities that have not adopted ASU 2015-02 should adopt ASU 2016-17 at the same time and apply the same transition method for both standards. Entities that already adopted ASU 2015-02 should apply ASU 2016-17 retrospectively to all periods beginning with the earliest annual period in which they adopted ASU 2015-02. Entities can adopt ASU 2016-17 immediately, including in an interim period. However, if an entity adopts the ASU in an interim period other than the first interim period of its fiscal year, it should compute and reflect the cumulative effect of the accounting change as of the beginning of the fiscal year that includes that interim period.

Scenario 2

Assume the same facts as Scenario 1 except that Bank A does not own any of party B’s equity.

In this situation, Bank A would exclude Party B’s interest from its evaluation of whether it is the primary beneficiary, even if Bank A and Party B are under common control. However, the conclusion that Bank A is the primary beneficiary would not change because Bank A still has a potentially significant
variable interest through its direct economic interest and other indirect economic interests.

**Scenario 3**

Assume the same facts as Scenario 2 except that Bank A also does not own any of party C’s equity.

In this situation, Bank A would not be the VIE’s primary beneficiary. No related party primary beneficiary analysis would be performed because the VIE has a single decision maker (Bank A), and there would be no group of parties under common control that meets the criteria to be the VIE’s primary beneficiary or a party for whom substantially all of the VIE’s activities involve or are conducted (excluding Bank A).

**Question 7.3.10.2: Evaluating Whether There Is Shared Power or a Single Decision Maker When an Entity Has Multiple Decision Makers**

Is power over an entity shared when the entity has multiple decision makers and, if not, could a party be considered a single decision maker for the entity in those situations?

**Background:** ASC paragraph 810-10-25-44 requires the related party tiebreaker guidance to be applied to determine the primary beneficiary of a VIE when either (a) a single decision maker that does not individually meet the primary beneficiary criteria in ASC paragraph 810-10-25-38A is part of a group of related parties under common control that collectively meets those criteria or (b) power over the VIE is shared. In addition, the related party guidance in ASC paragraph 810-10-25-44B applies for purposes of determining the primary beneficiary of a VIE only when the VIE has a single decision maker. Consequently, it is necessary to determine whether a VIE has a single decision maker or whether power over the VIE is shared when applying the related party guidance to determine the VIE’s primary beneficiary.

ASU 2015-02’s definition of decision maker indicates that an entity may have more than one decision maker. This raises the question of whether power over an entity is shared when the entity has multiple decision makers and how to evaluate when, if ever, a party would be considered a single decision maker in those situations.

**Interpretive Response:** We believe an entity does not have a decision maker when there is shared power. In addition, when an entity is controlled by voting interests, it can have at most only one decision maker (e.g., if one party holds a majority of the entity’s voting interests). This is consistent with ASU 2015-02’s definition of a decision maker and the provisions of ASC paragraph 810-10-25-38D, which states in part:

Power is shared if two or more unrelated parties together have the power to direct the activities of a VIE that most significantly impact the
VIE’s economic performance and if decisions about those activities require the consent of each of the parties sharing power. If a reporting entity concludes that power is not shared but the activities that most significantly impact the VIE’s economic performance are directed by multiple unrelated parties and the nature of the activities that each party is directing is the same, then the party, if any, with the power over the majority of those activities shall be considered to have the characteristic in paragraph 810-10-25-38A(a).

The characteristic in ASC subparagraph 810-10-25-38A(a) is the power to direct the activities that most significantly impact a VIE’s economic performance. The definition of a decision maker refers to the entity or entities with that power.

To meet the definition of a decision maker, we believe a party must have the contractual right to unilaterally make the decisions about one or more of the activities that significantly impact an entity’s economic performance. In addition, a party that individually meets the criterion in ASC subparagraph 810-10-25-38A(a) (the power criterion) is a single decision maker for purposes of applying the related party guidance in ASC Topic 810, Consolidation, as amended by ASU 2015-02. As discussed further below, it is possible for an entity to have multiple decision makers under the definition of a decision maker, but a single decision maker for purposes of applying the related party guidance.

While the party that individually meets the power criterion is a single decision marker, there could be a single decision maker that does not meet the power criterion because its decision maker fee is not a variable interest in the VIE. That party cannot be the primary beneficiary so evaluating whether it is the single decision maker does not affect its consolidation conclusion. However, that entity’s related parties that have variable interests in the VIE must decide whether that entity, or another entity in the related party group, has the characteristic of a single decision maker. The members of the related party group need to complete this analysis because whether the VIE has a single decision maker in the related party group may affect which, if any, variable interest holder within that group consolidates the VIE. See Question 7.3.10.1 for the decision tree about how a reporting enterprise should determine which party, if any, in a related party group should consolidate a VIE.

For example, consider an entity with three activities that significantly impact its economic performance – activities A, B, and C. Party X has the contractual right to unilaterally make the decisions about activity A, Party Y has the contractual right to unilaterally make the decisions about activity B, and Party Z has the contractual right to unilaterally make the decisions about activity C. In that scenario, Parties X, Y, and Z each meet the definition of a decision maker. Assuming activities A, B, and C are activities of the same nature, ASC paragraph 810-10-25-38D requires a determination of whether one of the parties is directing a majority of the activities. If so, then that party is deemed to individually meet the criterion in ASC subparagraph 810-10-25-38A(a) and
would be considered a single decision maker for purposes of applying the related party guidance. Assuming the nature of activities A, B, and C is not the same, ASC paragraph 810-10-25-38E requires a determination of which activity most significantly impacts the VIE’s economic performance. The party directing that activity is deemed to individually meet the criterion in ASC subparagraph 810-10-25-38A(a) and would be considered a single decision maker for purposes of applying the related party guidance. For example, if activity A has a greater impact on the entity’s economic performance than either activity B or activity C, then Party X would be considered a single decision maker for purposes of applying the related party guidance. While ASC paragraph 810-10-25-38E addresses only situations in which there are multiple unrelated parties that direct multiple dissimilar activities that affect the VIE’s economic performance, we believe related party groups would apply the same principle to identify whether there is a single decision maker and evaluate whether there is one member of the related party group that individually meets the power criterion in ASC subparagraph 810-10-25-38A(a).

When an entity has an outsourced manager with the contractual right to make the decisions about the activities that most significantly impact the entity’s economic performance, the outsourced manager only meets the definition of a decision maker if it is not subject to substantive kick-out rights or substantive participating rights. When evaluating whether an entity is a VIE, those rights would need to be exercisable by a simple majority or less of the equity-at-risk investors. When identifying the primary beneficiary of a VIE and applying the related party guidance, those rights would need to be exercisable by a single variable interest holder (including its related parties).

However, ASU 2015-02 sometimes describes an outsourced manager as a decision maker on the basis of its contractual decision-making rights without considering the effect of other parties’ rights such as kick-out rights. Paragraph BC35 of ASU 2015-02 states, "The equity holders may have power through voting rights in their equity-at-risk interests over the activities of a legal entity that most significantly impact the entity’s economic performance even if the entity has a decision maker." This is inconsistent with the definition of a decision maker in ASU 2015-02. If the equity-at-risk investors have power through voting rights, another party could not also have the power to direct the activities that most significantly impact the entity’s economic performance. Based on discussions with the FASB staff, we understand that this statement was worded incorrectly and was intended to refer to the outsourced manager’s contractual decision-making rights without considering the impact of the equity-at-risk investors’ power through voting rights.
Example 7.3.10.4: Multiple Unrelated Decision Makers

A VIE has three activities that significantly impact its economic performance—activities A, B, and C. Those activities are not activities of the same nature.

- Party X has the contractual right to unilaterally make the decisions about activity A.
- Party Y has the contractual right to unilaterally make the decisions about activity B.
- Party Z has the contractual right to unilaterally make decisions about activity C.
- Parties X, Y, and Z are not related parties. Activity A has a more significant impact on the VIE’s activities than activity B or activity C.

Party X has a below-market fee that is a variable interest under the provisions of ASC subparagraphs 810-10-55-37(a) and 55-37(d) and holds no other direct variable interests in the VIE. Investor W is a related party not under common control with Party X that holds a variable interest that absorbs 20% of the VIE’s expected losses and expected residual returns. Party X owns 10% of the common stock of Investor W. Neither Party X nor Investor W individually meets the criteria to be the VIE’s primary beneficiary. However, as a group, Party X and Investor W collectively meet the criteria to be the VIE’s primary beneficiary. (Note that this conclusion is based on the ASC paragraph 810-10-25-38E requirement to identify one party as the party with the power to direct the activities that most significantly impact a VIE’s economic performance when the activities that impact the VIE’s economic performance are directed by multiple unrelated parties and the nature of the activities that each party is directing is not the same.)
Because Party X is considered a single decision maker and is not under common control with Investor W, the related party tiebreaker guidance in ASC paragraph 810-10-25-44 does not apply and Party X is not required to consolidate the VIE. (Investor W would only be required to consolidate the VIE under the provisions of ASC paragraph 810-10-25-44B if substantially all of the VIE’s activities either involve or are conducted on its behalf.) Note that if Party X and Investor W were under common control, then the related party tiebreaker guidance in ASC paragraph 810-10-25-44 would apply and the party most closely associated with the VIE (which could potentially be Party X) would be required to consolidate the VIE.

Example 7.3.10.5: Multiple Related Party Decision Makers

Assume the same facts as Example 7.3.10.4, except as follows:

- Parties X, Y, and Z are related parties not under common control and the only variable interest holders of the VIE;
- Each party holds a 3% interest in each of the other parties;
- Party X holds a direct variable interest that absorbs 2% of the VIE’s expected losses and expected residual returns; and
- Parties Y and Z each hold a direct variable interest that absorbs 49% of the VIE’s expected losses and expected residual returns.

As discussed in Question 7.3.10.2 (and like Example 7.3.10.4), we believe that Party X is the single decision maker because it has the power to direct the activities that most significantly affect the VIE’s economic performance (activity A). However, while Party X meets the power criterion (because it has the contractual right to unilaterally make the decisions about activity A), it does not meet the potentially significant variable interest criterion in ASC subparagraph 810-10-25-38A(b).

While none of the parties individually meets the criteria to be the VIE’s primary beneficiary, the related parties as a group do meet the primary beneficiary criteria. Because Party X is considered a single decision maker and is not under common control with its related parties, the related party tiebreaker guidance in ASC paragraph 810-10-25-44 does not apply and Party X is not required to consolidate the VIE. (Party Y or Party Z would only be required to consolidate the VIE under the provisions of ASC paragraph 810-10-25-44B if substantially all of the VIE’s activities either involve or are conducted on either party’s behalf.)

Note that if Party X were under common control with either Party Y or Party Z, Party X would individually meet the criteria to be the primary beneficiary because ASC paragraph 810-10-25-42 would require Party X, as the single decision maker, to consider Party Y or Party Z’s interests (or both) in their entirety when evaluating whether it has a potentially significant variable interest.
under ASC subparagraph 810-10-25-38A(b). Party X must consider those 49% indirect interests in the VIE because (a) it has direct interests in Party Y and Party Z, and (b) Parties X, Y and Z are under common control.

As discussed in Question 7.3.10.1, in October 2016, the FASB changed the guidance about how a single decision maker should consider indirect interests held through related parties that are under common control. ASU 2016-17 requires the single decision maker to consider indirect interests held through related parties that are under common control on a proportionate basis. Under ASU 2016-17, Party X would not individually meet the potentially significant variable interest criterion in ASC subparagraph 810-10-25-38A(b) even if it were under common control with both Party Y and Party Z. This is because Party X’s obligation to absorb losses and right to receive benefits from the VIE would total only 4.94% (2% direct interest + 1.47% (3% x 49%) indirect interest through Party Y + 1.47% (3% x 49%) indirect interest through Party Z. Because no party would individually meet the primary beneficiary criteria, the related party tiebreaker guidance in ASC paragraph 810-10-25-44 would apply and the party most closely associated with the VIE (which could potentially be Party X) would be required to consolidate the VIE.

Question 7.3.10.3: Indirect Interests Held by Related Parties

Should a single decision maker include both direct and indirect variable interests in a VIE held by related parties when evaluating whether the related party group collectively meets the criteria to be the primary beneficiary of a VIE?

**Background:** If a single decision maker concludes that it is not the primary beneficiary of a VIE, the single decision maker should apply the guidance in ASC paragraph 810-10-25-44 when (1) the single decision maker and its related parties are under common control and (2) the related parties, as a group, meet the criteria to be the primary beneficiary of the VIE.

**Interpretive Response:** It depends. All relevant facts and circumstances should be considered by a single decision maker when determining whether both direct and indirect variable interests in a VIE held by related parties should be included in evaluating whether the related party group collectively meets the primary beneficiary criteria. The following examples illustrate when an indirect interest would be excluded or included in the evaluation.

**Example 7.3.10.6: Indirect Interests Excluded**

General Partner C is evaluating whether to consolidate Fund 4. Assume Fund 4 is a VIE. General Partner C does not individually meet both criteria to be the primary beneficiary of Fund 4. General Partner A, General Partner B, and General Partner C are 100% owned by Parent. None of the funds are
General Partner C has no interest in General Partner A, General Partner B, Fund 1, Fund 2, or Fund 3.

General Partner A and General Partner B are related parties to General Partner C because they are entities under common control. However, Funds 1, 2, and 3 are not under common control with General Partner C because they are not consolidated by General Partner A or General Partner B. We believe that it would be acceptable for General Partner C not to include General Partner A’s indirect interest of 4.1% ((8% × 35%) + (5% × 25%)) or General Partner B’s indirect interest of 1.8% (7% × 25%) when evaluating whether the related party group collectively meets the criteria to be the primary beneficiary of Fund 4. Therefore, General Partner C would not be required to determine which party in the related party group is most closely associated with and required to consolidate Fund 4. If the indirect interests of General Partner A and General Partner B were included in General Partner C’s evaluation, the related party group would collectively meet the primary beneficiary criteria and one of the general partners would be required to consolidate Fund 4.

Note that in Parent’s consolidated financial statements the indirect interests of General Partners A and B would be included in evaluating whether Parent is the primary beneficiary of Fund 4 because Funds 1, 2, and 3 are related parties of General Partner A and/or General Partner B. Therefore, Parent would be required to consolidate Fund 4.
Example 7.3.10.7: Indirect Interests Included

Modifying the facts in Example 7.3.10.6, assume General Partner B holds a 75% interest in Fund 3 but does not have a controlling financial interest in the fund and Fund 3 holds an 80% interest in Fund 4. Further assume that Fund 1 holds a 5% interest in Fund 4 and Fund 2 holds no interest in Fund 4. The purpose and design of Fund 3 is to invest in Fund 4. We believe that General Partner C would not include General Partner A’s indirect interest of 0.4% (8% × 5%) but would include General Partner B’s indirect interest of 60% (75% × 80%) when evaluating whether the related party group collectively meets the criteria to be the primary beneficiary of Fund 4 because Fund 3 was designed to invest in Fund 4. Therefore, the related party group would collectively meet the criteria to be the primary beneficiary of Fund 4 and General Partner C would determine which party in the related party group is most closely associated with and required to consolidate Fund 4.

Question 7.3.10.4: Related Parties Involved With Low-Income Housing Tax Credit Structures

Are investors in low-income housing tax credit structures subject to the related party guidance in ASC paragraph 810-10-25-44B with respect to parties for whom substantially all of a VIE’s activities involve or are conducted?

Interpretive Response: Not necessarily. Investors in low-income housing tax credit structures that qualify to apply the guidance in FASB Accounting
Standards Update 2014-01 (ASU 2014-01), Investments – Equity Method and Joint Venture (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects, are not required to apply the related party guidance in ASC paragraph 810-10-25-44B.

ASU 2014-01 allows investors to use the proportional amortization method to account for investments in qualified affordable housing projects if specified conditions are met. The revised related party guidance may have otherwise required a limited partner to consolidate the low-income housing tax credit partnership in the same circumstances. The FASB decided that the revised related party guidance should not override the guidance in ASU 2014-01.

7.3.20. Determining Which Party in a Related Party Group Is Most Closely Associated With a VIE

7.3.20.10. When power is shared between two or more related parties, or when a group of related parties under common control that includes a single decision maker whose fee is a variable interest collectively meets the characteristics to be considered the VIE’s primary beneficiary, the determination of which party within the related party group that is most closely associated with the VIE must be made. This evaluation requires judgment based on an analysis of all relevant facts and circumstances. No one factor is determinative; facts and circumstances will dictate how much emphasis can be placed on a particular consideration. We believe this will include determining for which party the operations of the VIE are critical, by understanding the operations and the assets of the evaluating enterprise. Based on comments made by a member of the SEC staff in a speech at the 2004 AICPA National Conference on Current SEC and PCAOB Developments, the SEC also believes that all facts and circumstances should be considered in the overall assessment of which party is most closely associated with the VIE. An excerpt from the speech follows:

Excerpt from Speech by Jane D. Poulin

It is important to read the words in [ASC paragraph 810-10-25-44] plainly. [ASC paragraph 810-10-25-44] requires an overall assessment of which party is the most closely associated with the entity. When considering questions under [ASC paragraph 810-10-25-44], the staff considers all the factors in [ASC paragraph 810-10-25-44] and any other factors that may be relevant in making this overall assessment. We do not view [ASC paragraph 810-10-25-44] to be a matter of checking the boxes for the four factors listed and adding up who has the most boxes checked. Instead we look at all relevant factors in their entirety considering the facts and circumstances involved. We have also been asked whether any of the factors in [ASC paragraph 810-10-25-44] carry more weight than any others or whether any of the factors in [ASC paragraph 810-10-25-44] are determinative. There is no general answer to this question. Instead, the facts and circumstances of the situation should be considered to determine whether one factor or another is more important.
7.3.20.20. In a speech at the 2010 AICPA National Conference on Current SEC and PCAOB Developments, another member of the SEC staff reiterated the need for consideration of relevant facts and circumstances in determining which party is most closely associated with a VIE. An excerpt from the speech follows:

**Excerpt from Speech by Wesley R. Bricker**

The determination of which member of a related party group is most closely associated with a variable interest entity generally is qualitative and dependent on the facts and circumstances. When determining which member is most closely associated with the variable interest entity, consider approaching the task plainly and with attention to the overall objective and control premise of the model.

7.3.20.30. In a speech at the 2014 AICPA National Conference on Current SEC and PCAOB Developments, a member of the SEC staff reaffirmed that a tiebreaker test needs to be performed only when no party in the related party group individually meets the definition of a primary beneficiary. An excerpt from the speech follows:

**Excerpt from Speech by Christopher F. Rogers**

Finally, the last VIE consolidation topic I want to touch on today is how to consider power and economics when related parties are under common control. The staff has received several questions recently regarding whether the related party tiebreaker 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 tiebreaker guidance or that that guidance is necessarily determinative unless no party in the common control group individually meets both characteristics of a primary beneficiary.

As indicated in the SEC staff speech, common control arrangements require careful consideration to determine if stated power is substantive. We agree with the staff’s observation that the related party tiebreaker guidance is not required where there is a single party in the common control group that meets both of the characteristics of a primary beneficiary and stated power is substantive. However, we believe the related party tiebreaker guidance often will be an important consideration in the evaluation of whether stated power is substantive. We also believe that the related party tiebreaker guidance is not applied if the entity in the related party group that is a single decision maker has a decision maker fee that is not a variable interest. In those cases, the other variable interest holders within the related party group should evaluate if substantially all of the VIE’s activities either involve or are conducted on behalf of an individual.
variable interest holder within the related party group. See Question 7.3.10.1. for further details.

Question 7.3.20.1: Determining the Primary Beneficiary in a Common Control Group

If the parties in a related party group all have a variable interest in the VIE and are under common control, how should ASC paragraph 810-10-25-44 be applied?

Interpretive Response: When the parties in a related party group are under common control, consideration of ASC paragraphs 810-10-15-13A and 15-13B will be necessary in determining which party in the common control group meets the ASC subparagraph 810-10-25-38A(a) power criterion. When evaluating substance in these situations, identifying whether the party that has the stated power to direct the activities that most significantly impact the VIE’s economic performance has a disproportionately small economic interest in the entity relative to other parties in the common control group (i.e., careful consideration of ASC paragraph 810-10-25-38G) is particularly important.

To illustrate this concept, assume NAW Corp. vests the power to direct the activities that most significantly impact the economic performance of KKB LLC (the VIE) with NAW’s wholly-owned subsidiary MDM Co. MDM’s fee is below market and therefore is a variable interest in KKB. MDM’s economic interests in KKB are disproportionately small relative to its power and do not meet the significant economic interest condition in ASC subparagraph 810-10-25-38A(b). HHL Inc., another wholly-owned subsidiary of NAW, holds the remaining economic interest in KKB, but does not meet the power condition in ASC subparagraph 810-10-25-38A(a). A determination of which subsidiary is most closely associated with KKB, but does not meet the power condition in ASC subparagraph 810-10-25-38A(a). A determination of which subsidiary is most closely associated with KKB must be made based on an analysis of all relevant facts and circumstances, including but not limited to the considerations in ASC subparagraphs 810-10-25-44(a) through 25-44(d). That subsidiary would be required to consolidate KKB. It would not be appropriate to conclude that NAW (the parent company) should directly consolidate KKB (and that neither subsidiary should) in that circumstance, unless NAW also holds a variable interest in the VIE and is deemed to be most closely associated with the VIE based on the provisions in ASC paragraph 810-10-25-44.

Even if MDM’s economic interest were significant enough to meet the condition in ASC subparagraph 810-10-25-38A(b), because the parties in the related party group are under common control, we believe it is appropriate to evaluate the substance of the stated arrangements based on an analysis of all relevant facts and circumstances, including but not limited to the considerations in ASC subparagraphs 810-10-25-44(a) through 25-44(d). If that analysis indicates that HHL is most closely associated with KKB, the separation of power and economics between MDM and HHL (i.e., the enterprises under common control) may be non-substantive. As such, even though MDM may appear to
meet the conditions in ASC paragraph 810-10-25-38A, it may be appropriate to conclude that HHL is the primary beneficiary of KKB.

7.3.20.35. In June 2017, the FASB issued a proposed ASU, Targeted Improvements to Related Party Guidance for Variable Interest Entities. The proposed amendments would remove the related party tie-breaker test and amend the consolidation guidance when a related party group of commonly controlled entities holds a controlling financial interest and no single entity within the related party group has a controlling financial interest. This proposed guidance would also apply to a related party group in which power is shared. The amended guidance would require consolidation by an individual member of the related party group that holds a variable interest in a VIE when substantially all of the VIE’s activities involve, or are conducted on behalf of, that member. If substantially all of the activities of the VIE do not involve (and are not conducted on behalf of) a single member of a related party group, the amended guidance would provide conditions for a reporting entity to consider in determining whether an individual member of a related party group has a controlling financial interest in the VIE. The proposal would also clarify that if the parent of a common control group has a controlling financial interest in a VIE on a consolidated basis, that parent is required to consolidate the VIE, regardless of whether any of its controlled subsidiaries consolidates the VIE. Comments on the proposal were due September 5, 2017.

PRINCIPAL-AGENCY RELATIONSHIP

7.3.20.40. The first factor provided in ASC paragraph 810-10-25-44 for identifying which party within a related party group is most closely associated with the VIE is the existence of a principal-agency relationship between the various parties in that related party group. For example, if one party acted as an agent of another party (the principal), this may indicate that the principal is most closely associated with the VIE because the agent is acting on the principal’s behalf. There are a variety of considerations, including other relevant accounting guidance that may need to be evaluated to determine whether a principal-agency relationship exists.

Question 7.3.20.2: Identifying a Principal-Agency Relationship

When should an agency relationship be considered to exist in evaluating the related party tiebreaker guidance in ASC paragraph 810-10-25-44, and how should the principal be identified if an agency relationship exists?

Interpretive Response: The answer depends on the facts and circumstances. We believe the guidance in ASC Topic 606 and ASC Subtopic 470-50 is helpful in identifying whether an agency relationship exists and in identifying the principal in the relationship, but is not the only consideration. We also believe the fact that an enterprise is a VIE’s decision maker indicates that the enterprise may be a principal in an agency relationship, and the fact that an enterprise is a principal in an agency relationship indicates that the enterprise
may be a VIE’s decision maker. Further, we believe that the de facto agent in a de facto agency relationship under the provisions of ASC subparagraph 810-10-25-43(d) should be viewed as an agent for purposes of the related party tiebreaker guidance in ASC paragraph 810-10-25-44. This would apply, for example, if Party A cannot sell, transfer, or encumber its interest in the VIE without Party B’s approval, but there is no corresponding requirement for Party B to obtain Party A’s approval for Party B to sell, transfer, or encumber its interest in the VIE. In that situation, Party A would be considered the agent and Party B the principal in a de facto agency relationship for purposes of the related party tiebreaker guidance in ASC paragraph 810-10-25-44.

RELATIONSHIP AND SIGNIFICANCE OF ACTIVITIES

7.3.20.50. The second factor provided in ASC paragraph 810-10-25-44 for identifying which party within a related party group is most closely associated with the VIE relates to the relationship and significance of the VIE to the individual parties within the related party group. The evaluation of this criterion should consider all relationships between the VIE and the parties in the related party group. Several factors may be considered by the reporting enterprise when performing this evaluation, including but not limited to whether:

- Any party in the related party group was significantly involved in the design or structuring of the VIE, including its primary purpose and operations;
- Any party in the related party group has operations that are substantially the same as those of the VIE;
- The variable interest in the VIE represents a large percentage of the total assets of a party in the related party group;
- The products or services provided by the VIE are significant inputs to the operations of a party in the related party group (e.g., if a party outsources production to the VIE);
- A significant portion of the products of a party in the related party group are sold to the VIE and/or represent key inputs to the VIE’s activities;
- Any employees of a party in the related party group also manage the activities of the VIE;
- The compensation for the VIE’s employees is tied to the operating results of any party in the related party group;
- A party in the related party group is required to fund the VIE’s operating losses;
- A party in the related party group funds research and development that is significant to the VIE’s operations;
- A large percentage of the VIE’s assets has been leased to/from a party in the related party group; and
• Any party in the related party group has the right (e.g., via a call option) to purchase the other parties’ interests in the VIE or sell (e.g., via a put option) its interests to another party in the related party group.

VARIABILITY ASSOCIATED WITH THE VIE’S ANTICIPATED ECONOMIC PERFORMANCE

7.3.20.60. The third factor provided in ASC paragraph 810-10-25-44 for identifying which party within a related party group is most closely associated with the VIE requires an evaluation of the VIE’s economic performance. When evaluating this factor, the reporting enterprise should consider the extent to which each party in the related party group is obligated to absorb losses of the VIE or entitled to receive benefits from the VIE as a result of the VIE’s economic performance. While ASC Subtopic 810-10 does not require enterprises to perform detailed expected loss calculations, it may be helpful to perform one when evaluating this factor, particularly where the qualitative factors do not clearly identify the primary beneficiary within the related party group. Where the variability absorbed by one party in a related party group significantly exceeds the variability absorbed by the other parties, that party may be the VIE’s primary beneficiary. However, the nature of the related party tiebreaker provisions is such that the party ultimately identified as the VIE’s primary beneficiary may not be the party within the related party group that has the most exposure to the VIE’s variability. For example, a parent company and a subsidiary may form a related party group with respect to a VIE, and the subsidiary may absorb a larger share of the VIE’s variability through its variable interests than the parent company. In those circumstances the parent company may be identified as the primary beneficiary because of its ability to direct the activities of the subsidiary.

DESIGN OF THE VIE

7.3.20.70. The last factor provided in ASC paragraph 810-10-25-44 for identifying which party within a related party group is most closely associated with the VIE relates to the design of the VIE. When evaluating this factor, the reporting enterprise should consider whether the VIE was designed or structured for the benefit or purpose of a particular party in the related party group. Similar to the primary beneficiary analysis, a party’s involvement in the design of a VIE may indicate that the party had the opportunity and the incentive to establish arrangements that result in the party most significantly benefiting from the arrangement. A securitization or other financing vehicle established by a transferor is an example of an entity structured for the benefit of a particular party (i.e., the transferor).

SHARED POWER CONSIDERATIONS

7.3.20.80. ASC paragraph 810-10-25-44 makes it clear that when power is shared, one party within the related party group must be identified as the party that is required to consolidate the VIE.
Question 7.3.20.3: Determining the Primary Beneficiary in a Shared Power Related Party Group

If two or more parties in a related party group contractually must consent to all of the decisions about the activities that most significantly impact a VIE’s economic performance (i.e., the related parties contractually share power) and collectively also meet the condition in ASC subparagraph 810-10-25-38A(b), how should ASC paragraph 810-10-25-44 be applied?

Interpretive Response: The FASB concluded that when power over the activities that most significantly impact a VIE’s economic performance is shared by a related party group that also collectively holds variable interests that meet the condition in ASC subparagraph 810-10-25-38A(b), one of the parties in the group must be identified as the primary beneficiary of the VIE. In that situation, the related party tiebreaker guidance in ASC paragraph 810-10-25-44 must be considered in identifying the party that is most closely associated with the VIE.
8. Initial Measurement and Subsequent Accounting for a Consolidated VIE

8.1. INITIAL MEASUREMENT

Example 8.1.1: Initial Consolidation of a Variable Interest Entity
Example 8.1.2: Initial Consolidation of a Variable Interest Entity Lessor
Example 8.1.3: Consolidating a VIE When the Fair Value of the Liabilities Exceeds the Fair Value of the Assets
Question 8.1.1: Issuance of Combined Financial Statements
Question 8.1.1a: Retention of a For-Profit Subsidiary’s VIE Accounting in the Consolidated Financial Statements of a Not-For-Profit (NFP) Entity
Question 8.1.3: Effect When a Reporting Enterprise Applies the Measurement Alternative in ASU 2014-13 to the CFE’s Stand-Alone Financial Statements
Question 8.1.4: Election to Apply the Measurement Alternative in ASU 2014-13

8.2. SUBSEQUENT ACCOUNTING

Example 8.2.1: Illustration of Intercompany Eliminations under the Voting and Variable Interest Models
Question 8.2.1: Accounting for Losses That Exceed the Controlling and Noncontrolling Interests
Question 8.2.2: Attributing Losses to Preferred Stock Noncontrolling Interests
Question 8.2.3: Attributing the VIE’s Net Income or Loss When No GAAP Equity Exists
Question 8.2.4: Accounting for the Acquisition of a Noncontrolling Interest

8.3. DECONSOLIDATION
GLOSSARY

Collateralized Financing Entity

A variable interest entity that holds financial assets, issues beneficial interests in those financial assets, and has no more than nominal equity. The beneficial interests have contractual recourse only to the related assets of the collateralized financing entity and are classified as financial liabilities. A collateralized financing entity may hold nonfinancial assets temporarily as a result of default by the debtor on the underlying debt instruments held as assets by the collateralized financing entity or in an effort to restructure the debt instruments held as assets by the collateralized financing entity. A collateralized financing entity also may hold other financial assets and financial liabilities that are incidental to the operations of the collateralized financing entity and have carrying values that approximate fair value (for example, cash, broker receivables, or broker payables).

SCOPE AND SCOPE EXCEPTIONS

15-17D The guidance on collateralized financing entities in this Topic provides a measurement alternative to Topic 820 on fair value measurement and applies to a reporting entity that consolidates a collateralized financing entity when both of the following conditions exist:

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

(b) The changes in the fair values of those financial assets and financial liabilities are reflected in earnings.

INITIAL MEASUREMENT

Valuation of Assets, Liabilities, and Noncontrolling Interests in a Newly Consolidated VIE

Entities under Common Control

30-1 If the primary beneficiary of a variable interest entity (VIE) and the VIE are under common control, the primary beneficiary shall initially measure the assets, liabilities, and noncontrolling interests of the VIE at amounts at which they are carried in the accounts of the reporting entity that controls the VIE (or would be carried if the reporting entity issued financial statements prepared in conformity with generally accepted accounting principles [GAAP]).
Entities Not under Common Control

30-2 The initial consolidation of a VIE that is a business is a business combination and shall be accounted for in accordance with the provisions in Topic 805.

All Primary Beneficiaries

30-3 When a reporting entity becomes the primary beneficiary of a VIE that is not a business, no goodwill shall be recognized. The primary beneficiary initially shall measure and recognize the assets (except for goodwill) and liabilities of the VIE in accordance with Sections 805-20-25 and 805-20-30. However, the primary beneficiary initially shall measure assets and liabilities that it has transferred to that VIE at, after, or shortly before the date that the reporting entity became the primary beneficiary at the same amounts at which the assets and liabilities would have been measured if they had not been transferred. No gain or loss shall be recognized because of such transfers.

30-4 The primary beneficiary of a VIE that is not a business shall recognize a gain or loss for the difference between (a) and (b):

(a) The sum of:
   (1) The fair value of any consideration paid
   (2) The fair value of any noncontrolling interests
   (3) The reported amount of any previously held interests

(b) The net amount of the VIE’s identifiable assets and liabilities recognized and measured in accordance with Topic 805.

Collateralized Financing Entities

30-10 When a reporting entity initially consolidates a variable interest entity that is a collateralized financing entity that meets the scope requirements in paragraph 810-10-15-17D, it may elect to measure the financial assets and the financial liabilities of the collateralized financing entity using a measurement alternative to Topic 820 on fair value measurement.

30-11 Under the measurement alternative, the reporting entity shall measure both the financial assets and the financial liabilities of the collateralized financing entity using the more observable of the fair value of the financial assets and the fair value of the financial liabilities. Any gain or loss that results from the initial application of this measurement alternative shall be reflected in earnings and attributed to the reporting entity in the consolidated statement of income (loss).

30-12 If the fair value of the financial assets of the collateralized financing entity is more observable, those financial assets shall be measured at fair value. The financial liabilities shall be measured in the initial consolidation as the difference between the following two amounts:
(a) The sum of:

(1) The fair value of the financial assets
(2) The carrying value of any nonfinancial assets held temporarily

(b) The sum of:

(1) The fair value of any beneficial interests retained by the reporting entity (other than those that represent compensation for services)
(2) The reporting entity’s carrying value of any beneficial interests that represent compensation for services.

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

30-13 If the fair value of the financial liabilities of the collateralized financing entity is more observable, those financial liabilities shall be measured at fair value. The financial assets shall be measured in the initial consolidation as the difference between the following two amounts:

(a) The sum of:

(1) The fair value of the financial liabilities (other than the beneficial interests retained by the reporting entity)
(2) The fair value of any beneficial interests retained by the reporting entity (other than those that represent compensation for services)
(3) The reporting entity’s carrying value of any beneficial interests that represent compensation for services

(b) The carrying value of any nonfinancial assets held temporarily.

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

30-14 The amount resulting from paragraph 810-10-30-12 or paragraph 810-10-30-13 shall be allocated to the less observable of the financial assets and financial liabilities (other than the beneficial interests retained by the reporting entity), as applicable, using a reasonable and consistent methodology.

30-15 The carrying value of the beneficial interests that represent compensation for services (for example, rights to receive management fees or servicing fees) and the carrying value of any nonfinancial assets held temporarily by the collateralized financing entity shall be measured in accordance with other applicable Topics.
If a reporting entity does not elect to apply the measurement alternative to a collateralized financing entity that meets the scope requirements in paragraph 810-10-15-17D, the reporting entity shall measure the fair value of the financial assets and the fair value of the financial liabilities of the collateralized financing entity using the requirements of Topic 820 on fair value measurement. If Topic 820 is applied, any initial difference in the fair value of the financial assets and the fair value of the financial liabilities of the collateralized financing entity shall be reflected in earnings and attributed to the reporting entity in the consolidated statement of income (loss).

SUBSEQUENT MEASUREMENT

Variable Interest Entities

The principles of consolidated financial statements in this Topic apply to primary beneficiaries’ accounting for consolidated variable interest entities (VIEs). After the initial measurement, the assets, liabilities, and noncontrolling interests of a consolidated VIE shall be accounted for in consolidated financial statements as if the VIE were consolidated based on voting interests. Any specialized accounting requirements applicable to the type of business in which the VIE operates shall be applied as they would be applied to a consolidated subsidiary. The consolidated entity shall follow the requirements for elimination of intra-entity balances and transactions and other matters described in Section 810-10-45 and paragraphs 810-10-50-1 through 50-1B and existing practices for consolidated subsidiaries. Fees or other sources of income or expense between a primary beneficiary and a consolidated VIE shall be eliminated against the related expense or income of the VIE. The resulting effect of that elimination on the net income or expense of the VIE shall be attributed to the primary beneficiary (and not to noncontrolling interests) in the consolidated financial statements.

Collateralized Financing Entities

A reporting entity that elects to apply the measurement alternative to Topic 820 on fair value measurement upon initial consolidation of a collateralized financing entity that meets the scope requirements in paragraph 810-10-15-17D shall consistently apply the measurement alternative for the subsequent measurement of the financial assets and the financial liabilities of that consolidated collateralized financing entity provided that it continues to meet the scope requirements in paragraph 810-10-15-17D. If a collateralized financing entity subsequently fails to meet the scope requirements, a reporting entity shall no longer apply the measurement alternative to that collateralized financing entity. Instead, it shall apply Topic 820 to measure those financial assets and financial liabilities that were previously measured using the measurement alternative.

Under the measurement alternative, a reporting entity shall measure both the financial assets and the financial liabilities of the collateralized financing entity using the more observable of the fair value of the financial assets and the
fair value of the financial liabilities, as described in paragraphs 810-10-30-12 through 30-15.

35-8 A reporting entity that applies the measurement alternative shall recognize in its earnings all amounts that reflect its own economic interests in the consolidated collateralized financing entity, including both of the following:

(a) The changes in the fair value of any beneficial interests retained by the reporting entity (other than those that represent compensation for services)

(b) Beneficial interests that represent compensation for services (for example, management fees or servicing fees).

35-9 If a reporting entity does not apply the measurement alternative to a collateralized financing entity that meets the scope requirements in paragraph 810-10-15-17D, the reporting entity shall measure the fair value of the financial assets and the fair value of the financial liabilities of the collateralized financing entity using the requirements of Topic 820 on fair value measurement. If Topic 820 is applied, any subsequent changes in the fair value of the financial assets and the changes in the fair value of the financial liabilities of the collateralized financing entity shall be reflected in earnings and attributed to the reporting entity in the consolidated statement of income (loss).

IMPLEMENTATION GUIDANCE AND ILLUSTRATIONS


55-205A A reporting entity has determined that it must consolidate a collateralized financing entity under this Topic and is eligible to and has elected to apply the measurement alternative in paragraphs 810-10-30-10 through 30-15 and 810-10-35-6 through 35-8. The reporting entity retains certain beneficial interests in the collateralized financing entity as compensation for its services and also retains other beneficial interests. Since initial consolidation, the collateralized financing entity has not settled any of the outstanding beneficial interests related to compensation for services. The collateralized financing entity’s only assets are corporate debt obligations, and its only liabilities (the beneficial interests issued by the collateralized financing entity) are thinly traded. The reporting entity determines that the fair value of the collateralized financing entity’s financial assets is more observable than the fair value of its financial liabilities. Because the fair value of the financial assets is more observable, the reporting entity determines the amount of the financial liabilities of the collateralized financing entity (other than those beneficial interests retained by the reporting entity) as follows.
<table>
<thead>
<tr>
<th></th>
<th>June 20, 20X4 (Measurement upon Initial Consolidation)</th>
<th>December 31, 20X4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of the financial assets</td>
<td>$ 100</td>
<td>$ 105</td>
</tr>
<tr>
<td>Plus: Carrying value of the nonfinancial assets</td>
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<td>5</td>
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<tr>
<td>Total value of the assets of the collateralized financing entity</td>
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<td>110</td>
</tr>
<tr>
<td>Less: Fair value of the beneficial interests retained by the reporting entity (other than those that represent compensation for services)</td>
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<td>12</td>
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<tr>
<td>Less: Carrying value of the beneficial interests related to compensation for services</td>
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<td>8</td>
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<tr>
<td>Financial liabilities related to the collateralized financing entity in consolidation</td>
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<td>90</td>
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<td>$ 20</td>
</tr>
<tr>
<td>Change in the net assets related to the collateralized financing entity</td>
<td>$ 4</td>
<td>$ 4</td>
</tr>
<tr>
<td>Changes in the beneficial interests attributable to the reporting entity</td>
<td>$ 4</td>
<td>$ 4</td>
</tr>
</tbody>
</table>

(a) The financial assets include $5 and $10 at June 20, 20X4, and December 31, 20X4, respectively, of cash held by the collateralized financing entity. The carrying value of the cash and cash equivalents is equal to the fair value.

(b) To determine the financial liabilities of the collateralized financing entity, the reporting entity uses the sum of the fair value of the financial assets and the carrying value of the nonfinancial assets. The nonfinancial assets of the collateralized financing entity are measured in accordance with other Topics.

(c) This amount represents the fair value of the beneficial interests retained by the reporting entity (other than those that represent compensation for services) determined in accordance with Topic 520. This amount is not included in the financial liabilities of the consolidated reporting entity because it does not represent an amount due to third-party beneficial interest holders.

(d) The reporting entity has rights to a portion of the beneficial interests through its compensation arrangement. That amount is measured in accordance with other Topics. That amount is not included in the financial liabilities of the consolidated reporting entity because it does not represent an amount due to third-party beneficial interest holders.

(e) The net assets related to the collateralized financing entity equal the reporting entity's beneficial interests (that is, the sum of the fair value of the beneficial interests retained [other than those that represent compensation] and the carrying value of beneficial interests that represent compensation for services). The change in the net assets is included in the reporting entity's consolidated net income (loss).

(f) The change in the net assets related to the collateralized financing entity equals the change in the value of the beneficial interests retained by the reporting entity, including the change in the carrying value of the beneficial interests representing compensation for services.

55-205AT A reporting entity has determined that it must consolidate a collateralized financing entity under this Topic and is eligible to and has elected to apply the measurement alternative in paragraphs 810-10-30-10 through 30-15 and 810-10-35-6 through 35-8. The reporting entity retains certain beneficial interests in the collateralized financing entity as compensation for its services and also retains other beneficial interests. Since initial consolidation, the collateralized financing entity has not settled any of the outstanding beneficial interests related to compensation for services. The collateralized financing entity’s only assets are mortgages with primarily unobservable inputs, and its only liabilities are beneficial interests issued in those assets. The beneficial interests of the collateralized financing entity are frequently traded, although not in an active market. Because the fair value of the financial liabilities is more observable, the reporting entity determines the amount of the financial assets of the collateralized financing entity as follows.
<table>
<thead>
<tr>
<th>Description</th>
<th>June 20, 20X4 (Measurement upon Initial Consolidation)</th>
<th>December 31, 20X4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of the financial liabilities (other than beneficial interests retained by the reporting entity)(^{(a)})</td>
<td>$ 90</td>
<td>$ 95</td>
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<tr>
<td>Plus: Fair value of the beneficial interests retained by the reporting entity (other than those that represent compensation for services)(^{(b)})</td>
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<td>12</td>
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<tr>
<td>Plus: Carrying value of the beneficial interests related to compensation for services(^{(c)})</td>
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<td>8</td>
</tr>
<tr>
<td>Total value of the financial liabilities of the collateralized financing entity(^{(d)})</td>
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<td>115</td>
</tr>
<tr>
<td>Less: Carrying value of the nonfinancial assets(^{(e)})</td>
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<td>5</td>
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<tr>
<td>Financial assets of the collateralized financing entity</td>
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</tr>
<tr>
<td>Net assets related to the collateralized financing entity(^{(f)})</td>
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<td>$ 20</td>
</tr>
<tr>
<td>Change in the net assets related to the collateralized financing entity(^{(g)})</td>
<td>$ 4</td>
<td>$ 4</td>
</tr>
<tr>
<td>Changes in the beneficial interests attributable to the reporting entity(^{(g)})</td>
<td>$ 4</td>
<td>$ 4</td>
</tr>
</tbody>
</table>

(a) This amount reflects the fair value of the beneficial interests held by third parties in the consolidated financial statements. While any beneficial interests retained by the reporting entity are financial liabilities of the collateralized financing entity, such amounts are eliminated in consolidation because they do not represent amounts due to third-party beneficial interest holders. This amount also includes $6 and $8 at June 20, 20X4, and December 31, 20X4, respectively, of payables held by the collateralized financing entity for securities purchased but not yet settled. The carrying amount of those payables approximates fair value.

(b) This amount represents the fair value of the beneficial interests retained by the reporting entity (other than those that represent compensation for services).

(c) The reporting entity holds beneficial interests that represent compensation for services. This amount is measured in accordance with other Topics.

(d) The total liabilities of the collateralized financing entity include the beneficial interests held by third parties, the beneficial interests retained by the reporting entity, and any beneficial interests related to compensation. The reporting entity’s beneficial interests (including those related to compensation) are financial liabilities of the collateralized financial entity that are eliminated in consolidation.

(e) The nonfinancial assets of the collateralized financing entity are measured in accordance with other Topics.

(f) The net assets related to the collateralized financing entity equal the reporting entity’s beneficial interests (that is, the sum of the fair value of the beneficial interests retained [other than those that represent compensation] and the carrying value of beneficial interests that represent compensation for services). The change in the net assets is included in the reporting entity’s consolidated net income (loss).

(g) The change in the net assets related to the collateralized financing entity equals the change in the value of the beneficial interests attributable to the reporting entity, including the change in the carrying value of the beneficial interests representing compensation for services.
8.1. INITIAL MEASUREMENT

8.1.10.10. ASC Subtopic 810-10, Consolidation – Overall, generally requires the primary beneficiary to initially measure the assets, liabilities, and noncontrolling interests of a newly consolidated VIE that is a business under ASC Topic 805, Business Combinations. The guidance in ASC Topic 805 does not apply to the initial measurement of the assets, liabilities, and noncontrolling interests of a newly consolidated VIE that is a business for:

(1) **Entities under common control.** If a VIE is under common control with its primary beneficiary, the primary beneficiary must initially measure the VIE’s assets, liabilities, and noncontrolling interests at the carrying amounts recorded by the enterprise that controls the primary beneficiary and the VIE (i.e., carryover basis should be used for all assets, liabilities, and noncontrolling interests and no gain or loss should be recognized). We believe this situation will arise infrequently because of the related party guidance in ASC Subtopic 810-10. However, it could arise when an entity changes from a voting interest entity to a VIE. For example, if a holding company has several subsidiaries and one of those subsidiaries becomes a VIE, it may be consolidated by another subsidiary of the holding company. In that situation, the primary beneficiary should initially measure all of the VIE’s assets, liabilities, and noncontrolling interests at their current carrying values on consolidation. No gain or loss should be recognized.

(2) **Assets and liabilities transferred to the VIE by the primary beneficiary.** If the primary beneficiary transferred assets or liabilities, or both, to a VIE upon, shortly before, or after becoming the primary beneficiary, those assets or liabilities, or both, initially should be measured by the primary beneficiary at their carryover basis. No gain or loss should be recognized. The FASB included this provision to prevent an enterprise from recognizing gains or losses selectively (and thereby affecting profits or losses) by transferring assets or liabilities, or both, to a VIE.

8.1.10.20. ASC Subtopic 810-10 requires the primary beneficiary of a newly consolidated VIE that is not a business not to recognize goodwill but otherwise to initially measure the assets, liabilities, and noncontrolling interests of the newly consolidated VIE under ASC Topic 805. As discussed in paragraph 2.3.50.25., the FASB recently issued Accounting Standards Update No. 2017-01, Clarifying the Definition of a Business (ASU 2017-01). Under ASU 2017-01, an integrated set of activities and assets (a set) is a business if it has, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs. Under the new model, fewer sets are expected to meet the definition of a business. ASU 2017-01 is effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2017. It is effective for other entities for annual periods in fiscal years beginning after

**Example 8.1.1: Initial Consolidation of a Variable Interest Entity**

Company A is involved with Entity B, a variable interest entity. Entity B is a business, as defined in ASC Topic 805. In 20X7, at the time of Company A’s initial involvement with Entity B, Company A determined that it was not the primary beneficiary of Entity B and, accordingly, has not consolidated Entity B. However, on July 1, 20X9, the governing documents and contractual arrangements among the parties involved with Entity B are revised, such that the power to direct the activities that most significantly impact Entity B’s economic performance is changed. As required by ASC Subtopic 810-10, Company A continuously reassesses whether changes in facts and circumstances result in a change in the determination of the primary beneficiary. As a result of the changes to the governing documents and contractual arrangements, Company A determines that it is now the primary beneficiary of Entity B.

This event is a business combination under ASC Topic 805 and, accordingly, at the acquisition date (July 1, 20X9), Company A must apply the acquisition method to its investment in Entity B, and include Entity B in its consolidated financial statements from that date forward. Thus, as of July 1, 20X9, Company A:

1. Remeasures its previously held interest in Entity B at its acquisition-date fair value and recognizes the resulting gain or loss, if any, in earnings;
2. Recognizes and measures the full amount of the identified assets acquired, the liabilities assumed, and the noncontrolling interest in Entity B under the recognition and measurement principles of ASC Topic 805; and
3. Recognizes and measures goodwill or a gain from a bargain purchase.

**Example 8.1.2: Initial Consolidation of a Variable Interest Entity Lessor**

An enterprise enters into a lease with a VIE lessor. The lease is structured so that the lessee classifies it as an operating lease and the lessor classifies it as a direct finance lease. In its separate financial statements, the lessor reports a direct finance lease receivable and unearned income. The net investment in the lease is the VIE lessor’s only asset.

If the lessee is required to consolidate the VIE (e.g. because it has a variable interest in the single-asset VIE lessor through a fixed price purchase option, a
residual value guarantee, or both), what kind of asset should the lessee recognize in its consolidated financial statements?

**Evaluation**

We believe no lease exists in the enterprise’s consolidated financial statements because the intercompany lease is eliminated in consolidation. Therefore, the enterprise should record on its balance sheet the physical asset that was on the VIE’s balance sheet immediately before entering into the lease arrangement.

**Example 8.1.3: Consolidating a VIE When the Fair Value of the Liabilities Exceeds the Fair Value of the Assets**

VIE A is the lessor in a single-asset leasing arrangement with Company B (the lessee), and has no other assets or operations other than those related to this leasing arrangement. VIE A was established by Entity C for the sole purpose of leasing out the asset and holding related debt, and C is the sole owner of A. Entity C has a 25% voting interest (preferred stock) in Company B, and therefore B and C are considered related parties under ASC Topic 850, *Related Party Disclosures*. Due to the existence of a fixed-price purchase option in the lease between VIE A and Company B, B is considered to have a variable interest in A. B has no voting interest or other variable interest in A. The related party group that includes Company B and Entity C has the characteristics in paragraph 810-10-25-38A. After applying the related party tiebreaker in paragraph 810-10-25-44, it is determined that, due to its use of the leased asset, Company B is most closely associated with VIE A. Company B is therefore required to consolidate VIE A. A’s asset and liability are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Book value</th>
<th>Fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset</td>
<td>200</td>
<td>100</td>
</tr>
<tr>
<td>Liability</td>
<td>150</td>
<td>200</td>
</tr>
</tbody>
</table>

**Evaluation**

The difference between the fair value of the asset and liability represents the fair value of VIE A’s equity at the date of consolidation. Because VIE A’s equity is owned 100% by Entity C, Company B would recognize a $100 debit to noncontrolling interest when consolidating VIE A; there is no excess of fair value of assets over liabilities and noncontrolling interests at the date of Company B’s initial consolidation of VIE A (i.e., the date on which B first became the primary beneficiary of A).

8.1.10.30. Goodwill that is recognized as a result of the initial consolidation of a VIE should be evaluated for impairment under the provisions of ASC Topic 350, *Intangibles—Goodwill and Other*. 
Question 8.1.1: Issuance of Combined Financial Statements

Is it appropriate for the primary beneficiary of a VIE to issue combined financial statements instead of consolidated financial statements?

Interpretive Response: No. Combined financial statements cannot be presented instead of consolidated financial statements by a reporting enterprise that is required to consolidate another entity. This is consistent with the guidance in AICPA Technical Questions and Answers (TIS) 1400.29, Consolidated Versus Combined Financial Statements Under FASB ASC 810, Consolidation, which states in part:

FASB ASC 810-10-05-6 permits combined financial statements in certain situations in which consolidated financial statements are not required… Furthermore, the starting point for the preparation of combined financial statements is two or more sets of financial statements that are prepared in accordance with GAAP; in the case of a primary beneficiary of a VIE, financial statements prepared in accordance with GAAP would be consolidated financial statements.

Whether it is appropriate to present combined financial statements when consolidation by one entity of another entity or entities in a common control group is not required depends on the facts and circumstances. ASC paragraph 810-10-55-1B states that “combined financial statements would be useful if one individual owns a controlling financial interest in several entities that are related in their operations…[and] might also be used to present the financial position and results of operations of entities under common management.”

Question 8.1.1a: Retention of a For-Profit Subsidiary’s VIE Accounting in the Consolidated Financial Statements of a Not-For-Profit (NFP) Entity

Should an NFP entity retain its for-profit subsidiary’s VIE accounting in its consolidated financial statements?

Interpretive Response: Yes. Although an NFP parent generally does not apply the VIE model to its direct investments/interests, an NFP parent entity should retain the VIE accounting applied by its for-profit subsidiary when it prepares its consolidated financial statements. We believe this view is consistent with the guidance in ASC paragraph 810-10-25-15, which states “For the purposes of consolidating a subsidiary subject to guidance in an industry-specific [ASC] Topic, an entity shall retain the industry-specific guidance applied by that subsidiary.”

Consider the following example:

NFP A applies the guidance in ASC Topic 958, Not-for-Profit Entities, and consolidates its wholly-owned for-profit subsidiary Entity B. Entity B, which does not prepare stand-alone financial statements, holds a 90% equity interest
in Entity C. NFP A has determined that Entity C is a VIE and Entity B is its primary beneficiary. Although ASC paragraph 810-10-15-17(a) indicates that NFPs generally are not subject to the VIE guidance in ASC Subtopic 810-10, we believe NFP A should retain the consolidation conclusion of Entity B and report Entity C in its consolidated financial statements under the variable interest entity model.

ASC paragraph 958-810-45-1 requires NFPs to present noncontrolling interests as a separate component of the appropriate class of net assets (i.e., unrestricted or restricted net assets, or net assets with or without donor restrictions after the NFP adopts ASU 2016-14, Presentation of Financial Statements of Not-for-Profit Entities) in the consolidated statement of financial position. Therefore, NFP A will report the 10% noncontrolling interest in Entity C as a separate component of the appropriate class of NFP A’s net assets.

8.1.10.40. In August 2014, the FASB issued Accounting Standards Update No. 2014-13 (ASU 2014-13), Measuring the Financial Assets and the Financial Liabilities of a Consolidated Collateralized Financing Entity. A collateralized financing entity (CFE) is an entity that holds financial assets such as asset-backed securities and issues beneficial interests to investors. These beneficial interests are usually debt instruments that are considered financial liabilities under U.S. GAAP. Because a CFE generally has little or no equity, it is typically a VIE under U.S. GAAP and subject to the consolidation requirements that apply to an entity not controlled through voting equity interests.

8.1.10.50. Many reporting entities that are required to consolidate a CFE elect the fair value option for all of the CFE’s eligible financial assets and financial liabilities. While a CFE’s assets are the sole source of repayment for its beneficial interests (i.e., its liabilities) and its beneficial interests are entitled to receive all of the cash flows from the CFE’s assets after payment of management fees and other expenses, fair value differences between a CFE’s assets and its beneficial interests may arise. Fair value differences may be caused by different liquidity discounts and duration mismatches between the CFE’s assets and its beneficial interests. Before issuance of ASU 2014-13, there was diversity in the accounting for differences between the fair value of a consolidated CFE’s assets and liabilities. Some primary beneficiaries recorded the difference in fair value as a gain or loss in the consolidated income statement. Others recorded the gain or loss in appropriated retained earnings.

8.1.10.60. ASU 2014-13 allows an alternative fair value measurement approach for certain consolidated CFES. The approach permits the parent of a consolidated CFE to measure the CFE’s financial assets and liabilities based on either the fair value of the financial assets or financial liabilities, whichever has the more observable inputs. If the fair value of the financial assets is determined to be more observable, then the financial liabilities are measured based on the fair value of the financial assets. Similarly, if the fair value of the financial liabilities is determined to be more observable, then the financial assets are measured based on the fair value of the financial liabilities.
8.1.10.70. The alternative measurement approach is available for CFEs that hold only:

- Financial assets and liabilities that are measured at fair value through net income;
- Assets or liabilities that are incidental to the financial assets and liabilities measured at fair value where the carrying value approximates fair value (e.g., cash or receivables and payables related to the financial assets and liabilities); and
- Nonfinancial assets that are held temporarily as a result of default or an attempt to restructure by the debtor on an underlying debt instrument held as an asset.

8.1.10.80. Assets transferred to a CFE by the parent continue to be measured using the parent’s measurement method (e.g., fair value or amortized cost) before the transfer. As a result, a CFE does not qualify for the alternative fair value measurement approach if assets measured by the parent at amortized cost or at fair value through other comprehensive income were transferred to the consolidated CFE.

8.1.10.90. Entities can elect the alternative measurement approach on an individual CFE-by-CFE basis upon initial consolidation of the CFE or at transition. ASU 2014-13 was effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2015. The effective date for other entities is for annual periods in fiscal years ending after December 15, 2016, and interim periods in fiscal years thereafter. Early adoption is permitted. ASU 2014-13 requires a modified retrospective application to all existing CFEs or retrospective application to all relevant periods beginning with the annual period in which the amendments in FAS 167 were initially adopted.


When a reporting enterprise does not apply the measurement alternative in ASU 2014-13, how should the reporting enterprise report the changes in measurement of the CFE’s financial assets and financial liabilities in its consolidated financial statements?

Interpretive Response: The reporting enterprise should apply other U.S. GAAP for the recognition, measurement, and presentation of the CFE’s financial assets and financial liabilities. For example, financial assets classified as available-for-sale securities under ASC Topic 320, Investments—Debt and Equity Securities, should be reported at fair value at period-end with changes in fair value reflected in other comprehensive income. The changes in measurement reported in net income and comprehensive income should be attributed to the reporting enterprise. A reporting enterprise should not reflect...
the measurement differences of a CFE’s financial assets and financial liabilities in appropriated retained earnings or other captions such as noncontrolling interest. This is supported by paragraph BC15 of ASU 2014-13, which states “The Task Force also decided that if a reporting entity does not elect to apply the measurement alternative for a consolidated collateralized financing entity that meets the scope requirements in this Update, the financial assets and the financial liabilities of the consolidated collateralized financing entity should be measured using Topic 820 and any initial or subsequent differences in the fair value of the financial assets and the fair value of the financial liabilities of the consolidated collateralized financing entity should be reflected in earnings and attributed to the reporting entity in the consolidated statement of net income (loss). The Task Force concluded that this clarification was necessary to prevent reporting entities that did not elect to apply the amendments in this Update from applying the diverse practices that are used today to present the measurement difference (for example, using noncontrolling interest and appropriated retained earnings).” [Emphasis added]. Although in the context of CFEs that meet the requirements for the measurement alternative, we believe this also applies to CFEs that do not meet the scope requirements in paragraph 810-10-15-17D. As a result, when adopting ASU 2014-13, a reporting enterprise should reclassify to retained earnings any amounts previously presented in another equity caption (such as appropriated earnings) in accordance with the transition provisions in ASC paragraph 810-10-65-6.

Question 8.1.3: Effect When a Reporting Enterprise Applies the Measurement Alternative in ASU 2014-13 to the CFE’s Stand-Alone Financial Statements

If a reporting enterprise applies the ASU 2014-13 measurement alternative to a consolidated CFE, is the CFE required to elect the fair value option under ASC Topic 825, Financial Instruments, in its stand-alone financial statements?

Interpretive Response: No. ASC paragraph 810-10-15-17D states that the measurement alternative to ASC Topic 820, Foreign Currency Matters, on fair value measurement applies to a reporting entity that consolidates a CFE. ASU 2014-13 did not change the fair value option guidance in ASC Topic 825; it remains an entity-by-entity decision to elect the fair value option on eligible items. As a result, a CFE is not required to elect the fair value option in its stand-alone financial statements when the CFE’s parent applies the measurement alternative in ASU 2014-13.

We also believe that the measurement alternative election in ASU 2014-13 can be made at any level in the chain of parent-subsidiary relationships so that a subsidiary that consolidates a CFE could elect the measurement alternative in its consolidated financial statements even if its parent elects not to do so.
Question 8.1.4: Election to Apply the Measurement Alternative in ASU 2014-13

Is a reporting enterprise required to consistently use the financial assets or the financial liabilities as the more observable fair value for all consolidated CFEs to which the measurement alternative in ASU 2014-13 is applied?

Interpretive Response: No. Although not explicitly stated in ASU 2014-13, the standard provides a measurement alternative as opposed to an accounting policy election. Throughout ASU 2014-13 a collateralized financing entity is referred to in the singular. Further, paragraph 810-10-30-16 states that “If a reporting entity does not elect to apply the measurement alternative to a collateralized financing entity that meets the scope requirements in paragraph 810-10-15-17D, the reporting entity shall measure the fair value of the financial assets and the fair value of the financial liabilities of the collateralized financing entity using the requirements of Topic 820 on fair value measurement.” This indicates that electing the measurement alternative is made on a CFE-by-CFE basis, and therefore the determination of the more observable of the fair value of the financial assets or financial liabilities also is made on a CFE-by-CFE basis.

8.2. SUBSEQUENT ACCOUNTING

8.2.10.10. After initial measurement, ASC Subtopic 810-10 generally requires the primary beneficiary to account for the assets, liabilities, and noncontrolling interests of a consolidated VIE as though they were consolidated based on voting interests. ASC paragraph 810-10-35-3 states that the consolidated entity should follow the guidance in ASC Section 810-10-45 and ASC paragraphs 810-10-50-1 through 50-1B, which pertains to the elimination of intra-entity balances and transactions and other matters. The VIE’s primary beneficiary is required to eliminate all transactions and balances with the VIE in its consolidated financial statements, regardless of whether a noncontrolling interest exists.

8.2.10.20. One significant difference that exists between the subsequent measurement requirements for VIEs and voting interest entities is that the guidance in the Variable Interest Entities Subsections of ASC 810-10 does not permit the elimination of intercompany profits or losses (including intercompany fees) to be attributed to the noncontrolling interests. That is, the effect of intercompany eliminations must be attributed solely to the primary beneficiary. This differs from the guidance for voting interest entities in ASC paragraph 810-10-45-18, which states that the elimination of intra-entity income or loss may be allocated between the parent and noncontrolling interests. Example 8.2.1 illustrates the differences between the requirements for eliminating intercompany transactions for voting and variable interest entities.
Example 8.2.1: Illustration of Intercompany Eliminations under the Voting and Variable Interest Models

Upon formation in 20X1, Entity CKW (CKW), a VIE, was capitalized with a $100 equity investment from ABC Corporation (ABC) and a $5,000 loan from XYZ Fund (XYZ). Because XYZ directs the activities that most significantly impact CKW’s economic performance, it is deemed to be CKW’s primary beneficiary. During 20X1, XYZ recognized interest income of $500 based on the loan’s 10% annual interest rate. In this example, assume that the loan is the only intercompany transaction between CKW and XYZ and that no other capital transactions occurred after formation.

**Intercompany Eliminations under the Voting Interest Model (ASC paragraph 810-10-45-18)**

<table>
<thead>
<tr>
<th></th>
<th>XYZ</th>
<th>CKW</th>
<th>Eliminating Entries</th>
<th>Consolidated XYZ</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>$10,000</td>
<td>$2,500</td>
<td></td>
<td>$12,500</td>
</tr>
<tr>
<td>Cost of Sales</td>
<td>8,000</td>
<td>1,500</td>
<td></td>
<td>9,500</td>
</tr>
<tr>
<td>Margin</td>
<td>2,000</td>
<td>1,000</td>
<td></td>
<td>3,000</td>
</tr>
<tr>
<td>Other</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest Income</td>
<td>500</td>
<td>-</td>
<td>(500)</td>
<td>-</td>
</tr>
<tr>
<td>Interest Expense</td>
<td>-</td>
<td>500</td>
<td>500</td>
<td>-</td>
</tr>
<tr>
<td>NCI</td>
<td>-</td>
<td>-</td>
<td>(1,000)</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Net Income after NCI</td>
<td>$2,500</td>
<td>$500</td>
<td>$(1,000)</td>
<td>$2,000</td>
</tr>
</tbody>
</table>

As illustrated above, the effect of the eliminating entry on the subsidiary’s net income and expense has been attributed to the noncontrolling interests. That is, the intercompany interest expense of $500, which was eliminated for CKW, was allocated to the noncontrolling interest in direct proportion to the equity ownership in CKW.

**Intercompany Eliminations under the Variable Interest Model (ASC paragraph 810-10-35-3)**

<table>
<thead>
<tr>
<th></th>
<th>XYZ</th>
<th>CKW</th>
<th>Eliminating Entries</th>
<th>Consolidated XYZ</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>$10,000</td>
<td>$2,500</td>
<td></td>
<td>$12,500</td>
</tr>
<tr>
<td>Cost of Sales</td>
<td>8,000</td>
<td>1,500</td>
<td></td>
<td>9,500</td>
</tr>
<tr>
<td>Margin</td>
<td>2,000</td>
<td>1,000</td>
<td></td>
<td>3,000</td>
</tr>
<tr>
<td>Other</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest Income</td>
<td>500</td>
<td>-</td>
<td>(500)</td>
<td>-</td>
</tr>
<tr>
<td>Interest Expense</td>
<td>-</td>
<td>500</td>
<td>500</td>
<td>-</td>
</tr>
<tr>
<td>NCI</td>
<td>-</td>
<td>-</td>
<td>(500)</td>
<td>(500)</td>
</tr>
<tr>
<td>Net Income after NCI</td>
<td>$2,500</td>
<td>$500</td>
<td>$(500)</td>
<td>$2,500</td>
</tr>
</tbody>
</table>
When eliminating intercompany transactions upon the consolidation of a VIE, the entire effect of such eliminations is attributed to the primary beneficiary (XYZ). While XYZ’s interest income has been eliminated, net income remains unchanged at $2,500. This acknowledges that the equity holder (ABC) is only legally and economically entitled to the $500 of net income earned by CKW.

In general, calculating the amount of a subsidiary’s net income to attribute to noncontrolling interests based on the subsidiary’s post-elimination net income is consistent with the ASC paragraph 810-10-45-18 guidance for voting interest entities. Conversely, calculating the amount of a subsidiary’s net income to attribute to noncontrolling interests on the basis of the subsidiary’s pre-elimination net income generally is consistent with the ASC paragraph 810-10-35-3 requirements for VIEs. If the example above were modified so that XYZ owned 60% of CKW’s equity, the amount of CKW’s net income attributable to noncontrolling interests (i.e., ABC) could be calculated using this approach as $400 ($1,000 post-elimination net income × 40%) under the ASC paragraph 810-10-45-18 guidance for voting interest entities, and $200 ($500 pre-elimination net income × 40%) under the ASC paragraph 810-10-35-3 requirements for VIEs.

8.2.10.30. Consistent with the model for voting interest entities described in ASC paragraph 810-10-45-21, losses attributable to noncontrolling interests may exceed the noncontrolling interest equity in a consolidated VIE. In these circumstances, the noncontrolling interests should continue to be attributed their share of excess losses, even if that allocation results in a deficit balance.

Question 8.2.1: Accounting for Losses That Exceed the Controlling and Noncontrolling Interests

Should losses that exceed the investments of controlling and noncontrolling interest holders in a VIE be recognized by the primary beneficiary in consolidation?

Background

To fund their operations, some VIEs may issue limited recourse notes that provide for payment solely from the VIE’s operations. There may be situations when losses of the VIE exceed the investments of the controlling and noncontrolling interest holders. These losses will be absorbed by the VIE’s other variable interest holders rather than the VIE’s stockholders.

Interpretive Response: As stated in ASC paragraph 810-10-35-3, after initial measurement, the assets, liabilities, and noncontrolling interests of a consolidated VIE are accounted for in consolidated financial statements as if the VIE were consolidated based on voting interests. Accordingly, liabilities of the consolidated VIE should not be reduced to reflect losses that will be absorbed by variable interest holders other than the primary beneficiary and other equity investors. Losses should continue to be recognized and attributed.
to the controlling and noncontrolling interests, even if that allocation results in a deficit balance.

**Question 8.2.2: Attributing Losses to Preferred Stock Noncontrolling Interests**

Where a consolidated VIE’s losses have exceeded the primary beneficiary’s investment, should the noncontrolling interests that are not common stock interests be reduced as a result of those losses?

**Background**

In certain situations, a reporting enterprise may be the primary beneficiary of a VIE that has both common and preferred stock. The common and preferred shares that are not held by the primary beneficiary are classified as noncontrolling interests in the consolidated financial statements.

Interpretive Response: Noncontrolling interests that are legal form common stock should generally be allocated earnings and other comprehensive income, unless a substantive profit-sharing arrangement exists. Furthermore, as stated in ASC paragraph 810-10-45-21, losses should be attributed to noncontrolling interests even when the noncontrolling interests have been reduced to zero.

Unlike common stock, preferred stock is generally entitled to a liquidation preference consisting of the paramount or cumulative unpaid dividends or both (i.e., it ordinarily does not have the characteristics of a residual equity interest in the VIE). Under ASC paragraph 810-10-10-1, consolidated financial statements are intended to present “…the results of operations and the financial position of a parent entity and its subsidiaries essentially as if the group were a single entity…” Accordingly, preferred stock noncontrolling interests should be classified and accounted for within the consolidated financial statements in the same manner as preferred stock issued by the primary beneficiary. As a result, we believe the VIE’s earnings should be attributed to the preferred stock noncontrolling interest based on its stated dividend and liquidation rights (i.e., losses of the VIE generally would not be attributed to preferred stock noncontrolling interests). However, reporting enterprises should carefully evaluate the terms of the preferred stock before reaching a conclusion, as certain preferred shares may not have a liquidation preference and instead represent a residual equity interest in the entity. In these circumstances, we believe it would be appropriate to attribute losses to the noncontrolling preferred stock interest because the shares have the characteristics of common stock.
Question 8.2.3: Attributing the VIE’s Net Income or Loss When No GAAP Equity Exists

Should the primary beneficiary of an entity that has no U.S. GAAP equity interests attribute any of the entity’s net income or loss to other parties?

Background

A VIE may be established with no U.S. GAAP equity interests, such as a VIE established to issue beneficial interests for the sole purpose of acquiring one or more assets. In that example, the specific assets held by the VIE are the sole source of payment of the beneficial interests.

Interpretive Response: No. None of the entity’s net income or loss should be attributed to other parties if the entity has no U.S. GAAP equity – the primary beneficiary should recognize all of the profits and losses for the period that it is the primary beneficiary. That is, there will be a timing difference between changes in fair value of the assets that affect the VIE’s net income and the attribution of those changes in fair value to other beneficial interest holders.

Although it is not appropriate to attribute any portion of the entity’s net income or loss to parties other than the primary beneficiary if the entity has no GAAP equity, in many situations the beneficial interests may contain embedded derivatives. If bifurcated and separated, accounting for the embedded derivatives at fair value under the provisions of ASC Topic 815, Derivatives and Hedging, may affect the primary beneficiary’s net income in substantially the same way as attributing some of the entity’s net income or loss to the beneficial interest holders based on their share of the beneficial interests in the entity.

Question 8.2.4: Accounting for the Acquisition of a Noncontrolling Interest

How should a primary beneficiary’s acquisition of a noncontrolling interest in a consolidated VIE be accounted for?

Interpretive Response: As stated in ASC paragraph 810-10-45-23, “changes in a parent’s ownership interest while the parent retains its controlling financial interest in its subsidiary shall be accounted for as equity transactions…Any difference between the fair value of the consideration received or paid and the amount by which the noncontrolling interest is adjusted shall be recognized in equity attributable to the parent.” Because the acquisition of a noncontrolling interest by the primary beneficiary is an equity transaction, the difference between the consideration paid and the carrying value of the noncontrolling interest should be reflected directly in equity rather than in net income.
8.2.10.40. ASC paragraph 810-10-25-15 indicates that any specialized accounting requirements that apply to the type of business in which the VIE operates must be applied as they would be applied to a consolidated subsidiary. This requirement may have industry-specific implications (e.g., for broker-dealers in securities). If a broker-dealer is required to consolidate one of its investees that is a VIE, the broker-dealer may not account for the assets and liabilities of the consolidated VIE at fair value unless the VIE is otherwise required to recognize its assets and liabilities at fair value under existing U.S. GAAP (e.g., if the VIE investee is an investment company).

8.2.10.50. When a reporting enterprise consolidates a CFE that meets the scope requirements in ASC paragraph 810-10-15-17D, the reporting enterprise may elect to measure the CFE’s financial assets and liabilities based on either the fair value of the financial assets or financial liabilities, whichever has the more observable inputs. As a result, when the measurement alternative is elected, the income statement effect of consolidating the CFE would be equal to the changes in the fair value of the reporting enterprise’s owned beneficial interests in the CFE. When the measurement alternative is not elected, the reporting entity should measure the fair value of the financial assets and the fair value of the financial liabilities of the CFE using the requirements of ASC Topic 820. In this situation, any subsequent changes in the fair value of the financial assets and financial liabilities of the CFE should be reflected in earnings and attributed to the reporting entity in the consolidated statement of operations.

8.3. DECONSOLIDATION

8.3.10.10. Reporting enterprises are required to deconsolidate a VIE if they no longer have a controlling financial interest in that VIE. This deconsolidation should be reflected upon the occurrence of the event triggering deconsolidation. It would be inappropriate for a reporting enterprise to deconsolidate the VIE in a prior reporting period for comparability or other purposes. Upon deconsolidation, reporting enterprises should also evaluate whether the deconsolidation event triggers discontinued operations treatment under ASC Subtopic 205-20, Presentation of Financial Statements - Discontinued Operations. The deconsolidation accounting requirements that apply to VIEs are the same as those that apply to voting interest entities in ASC paragraphs 810-10-40-3A through 40-6.
9. Presentation and Disclosure

9.1. OVERVIEW

9.2. PRESENTATION REQUIREMENTS

- Question 9.2.1: Elective Separate Presentation of a Consolidated VIE’s Assets and Liabilities
- Question 9.2.2: Manner of Separate Presentation of a Consolidated VIE’s Assets and Liabilities
- Question 9.2.3: Aggregation for Purposes of Separate Presentation
- Question 9.2.4: Separate Presentation in an UPREIT Structure

9.3. DISCLOSURE REQUIREMENTS

- 9.3.10. Disclosure Objectives
- 9.3.20. Aggregation of VIE Disclosures
  - Question 9.3.20.1: Disclosures When Individually Insignificant Variable Interests Are in Aggregate Significant to the Enterprise
- 9.3.30. Specific Disclosures of Consolidated and Non-Consolidated VIE Information
  - Question 9.3.30.1: Disclosure of a Non-Primary Beneficiary’s Maximum Exposure to Loss
- 9.3.40. Common Control Leasing Arrangements for a Private Company
- 9.3.50. Collateralized Financing Entities
9.1. OVERVIEW

9.1.10.10. One of the FASB’s primary objectives in issuing Accounting Standards Update No. 2009-17 (ASU 2009-17), Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities (originally issued as FASB Statement No. 167, Amendments to FASB Interpretation No. 46(R) (Statement 167)), was to expand and enhance existing presentation and disclosure requirements for enterprises involved with VIEs. These requirements are designed to ensure that investors have transparent and useful information about an enterprise’s involvement with, and associated risks from its involvement with, a VIE, regardless of whether the enterprise is the VIE’s primary beneficiary. The presentation and disclosure requirements of ASC Topic 810, Consolidation, which were not affected by the issuance of FASB Accounting Standards Update No. 2015-02 (ASU 2015-02), Amendments to the Consolidation Analysis, are incremental to any other required disclosures under other relevant U.S. GAAP, including those related to securitization vehicles contained within ASC Topic 860, Transfers and Servicing.

9.2. PRESENTATION REQUIREMENTS

Excerpt from ASC Subtopic 810-10

45-25 A reporting entity shall present each of the following separately on the face of the statement of financial position:

(a) Assets of a consolidated variable interest entity (VIE) that can be used only to settle obligations of the consolidated VIE

(b) Liabilities of a consolidated VIE for which creditors (or beneficial interest holders) do not have recourse to the general credit of the primary beneficiary.

9.2.10.10. The FASB considered a linked presentation model in which certain assets of a consolidated VIE would be classified separately on an enterprise’s balance sheet and netted against liabilities that are repaid solely from the cash flows of those assets. However, the Board decided against this approach because it concluded that a linked presentation model would represent a significant change that would be more appropriate to develop as part of a joint project with the IASB.
9.2.10.20. The FASB concluded that separate presentation should be required by enterprises for (a) assets of a consolidated VIE that could be used only to settle obligations of the consolidated VIE and (b) liabilities of a consolidated VIE for which creditors (or beneficial interest holders) do not have recourse to the general credit of the primary beneficiary. Such assets and liabilities must be presented on a gross basis unless other applicable U.S. GAAP allows for net presentation.

9.2.10.30. Assets and liabilities of consolidated VIEs that do not meet the criteria described in paragraph 9.2.10.20 do not require separate presentation and can be reported together in their natural classifications (e.g., receivables, investments, fixed assets, accounts payable, notes payable, etc.) with the other consolidated assets and liabilities of the enterprise.

9.2.10.40. Before applying the separate presentation requirements, enterprises should first eliminate all intra-entity balances and transactions associated with the consolidated VIE under ASC paragraph 810-10-45-1. Examples of such transactions include investments in and loans made to VIEs by the enterprise.

<table>
<thead>
<tr>
<th>Question 9.2.1: Elective Separate Presentation of a Consolidated VIE’s Assets and Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>If an enterprise is not required to separately present the assets and liabilities of a consolidated VIE, is it permitted to make an accounting policy election to do so?</td>
</tr>
<tr>
<td><strong>Interpretive Response:</strong> Yes. We believe that an enterprise may make an accounting policy election to separately present assets and liabilities that are not required to be separately presented under ASC paragraph 810-10-45-25 if the statement of financial position clearly distinguishes between those assets and liabilities that are required to be separately presented and those that are not. If an enterprise adopts this accounting policy, it should consistently apply it to the assets and liabilities of all consolidated VIEs.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Question 9.2.2: Manner of Separate Presentation of a Consolidated VIE’s Assets and Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Where separate presentation is required or elected, may an enterprise present the total assets and total liabilities of a consolidated VIE on two respective single lines in the statement of financial position?</td>
</tr>
</tbody>
</table>
| **Interpretive Response:** No. ASC paragraph 810-10-35-3 states that the principles of consolidated financial statements in ASC Topic 810 apply to the accounting by primary beneficiaries for consolidated variable interest entities. Furthermore, that paragraph also states that after initial measurement, the assets, liabilities, and noncontrolling interests of consolidated variable interest
entities should be accounted for in the enterprise’s consolidated financial statements as if the entity were consolidated based on voting interests.

The FASB considered, but rejected, single-line presentation of the assets and liabilities of consolidated VIEs. The Board decided that separate presentation of the assets of consolidated VIEs should be required when those assets can be used only to settle the VIEs’ obligations and separate presentation of the liabilities of consolidated VIEs should be required when the VIEs’ creditors (or beneficial interest holders) do not have recourse to the general credit of the primary beneficiary. When assets or liabilities are required to be presented separately under ASC paragraph 810-10-45-25, we believe that these amounts should be presented in their natural classifications (e.g., receivables, investments, fixed assets, accounts payable, notes payable, etc.) either as separate line items on the balance sheet or disclosed parenthetically on the balance sheet line item in which they are included. For example, an enterprise could present available-for-sale investments held by a VIE on a separate line from all other available-for-sale investments of the enterprise on the balance sheet, or it could present a single line item for available-for-sale investments and parenthetically disclose the available-for-sale investments held by the VIE. ASC Topic 810 does not require separate presentation in the income statement or cash flows statement of the operating results or cash flows of consolidated VIEs.

**Question 9.2.3: Aggregation for Purposes of Separate Presentation**

May an enterprise aggregate assets and liabilities of multiple consolidated VIEs under the separate presentation requirements of ASC paragraph 810-10-45-25?

Interpretive Response: Yes. When separately presenting assets and liabilities of consolidated VIEs under ASC paragraph 810-10-45-25, we believe it is appropriate to consider the aggregation principles in ASC paragraphs 810-10-50-9 and 50-10, which are presented in the Disclosure Requirements section that follows.

**Question 9.2.4: Separate Presentation in an UPREIT Structure**

In an UPREIT structure in which a consolidated operating partnership (OP) is a VIE, may a REIT disclose, rather than present separately on the face of the consolidated statement of financial position, the OP’s assets that can be used only to settle its obligations and the OP's liabilities for which creditors do not have recourse to the general credit of the REIT?

**Background:** Real estate investment trusts (REITs) often employ a structure referred to as an umbrella partnership real estate investment trust (UPREIT). In a typical UPREIT structure, the REIT is the sole general partner of the OP and
generally also holds a large majority of the limited partnership interests of the OP. In such a structure, the REIT may have no (or little) other assets, liabilities, or operations other than its interest in the operating partnership.

In an UPREIT structure, the limited partner voting interests of the OP (excluding those held by the general partner and related parties) typically lack substantive kick-out rights or participating rights because a simple majority of those limited partners generally lack the ability to exercise those rights. Consequently the OP is considered a VIE and the REIT is required to present separately on the face of the statement of financial position the assets of the OP that can be used only to settle the OP's obligations and the OP's liabilities for which creditors do not have recourse to the general credit of the REIT. As discussed in Question 9.2.2, the REIT should present these amounts in their natural classifications (e.g., receivables, investments, fixed assets) either as separate line items on the balance sheet or disclosed parenthetically on the balance sheet line item in which they are included.

**Interpretive Response:** When all or substantially all of the assets and liabilities presented in the REIT's consolidated balance sheet are assets and liabilities of the OP (because the REIT primarily runs its operations through the OP and has minimal activity outside the OP) or other consolidated VIEs, we believe it is acceptable for the reporting entity to disclose in the financial statement notes, rather than present in the balance sheet, the information required by ASC paragraph 810-10-45-25 as it relates to the OP. We do not believe this specific fact pattern was contemplated when the FASB issued the current presentation requirements and therefore do not believe note disclosure would be considered an accounting error. We understand, based on informal discussions, that the SEC staff concurs with this analysis.

The information disclosed in the notes should be in sufficient detail to enable financial statement users to understand the REIT's involvement with the OP, and associated risks, consistent with the VIE disclosure objectives in ASC paragraph 810-10-50-2AA and include any other disclosures required under Section 810-10-50 related to the OP.

A reporting entity that elects to disclose, rather than separately present in the consolidated balance sheet, the information required in ASC paragraph 810-10-45-25 should have processes and controls in place to monitor whether that presentation remains acceptable.

Note that the above guidance applies only to the REIT's interest in the OP when all or substantially all of the assets and liabilities of the REIT are assets and liabilities of the OP. If, however, the OP holds variable interests in other entities determined to be VIEs (i.e., the REIT has an indirect interest in lower level VIEs), the REIT (and OP) should apply the guidance in ASC paragraph 810-10-45-25 in determining whether those assets and liabilities need to be presented separately on the balance sheet and whether disclosure is required under the disclosure provisions of Section 810-10-50.
9.3. DISCLOSURE REQUIREMENTS

9.3.10. Disclosure Objectives

9.3.10.10. ASU 2009-17 created several incremental and revised disclosures related to an enterprise’s involvement with VIEs, regardless of whether the VIEs are consolidated, in response to financial statement user concerns that the associated risks were often insufficiently disclosed and not provided on a timely basis under the previous requirements. The FASB’s objective in making these revisions was to provide increased transparency about VIE activities within an enterprise’s financial statements. In particular, ASU 2009-17 broadened the scope of the disclosure requirements to include nonpublic entities that were previously exempt from certain VIE disclosure requirements and introduced some new and modified requirements for public entities. ASU 2015-02 did not change any of the disclosure requirements introduced in ASU 2009-17.

Excerpt from ASC Subtopic 810-10

50-2AA The principal objectives of this Subsection’s required disclosures are to provide financial statement users with an understanding of all of the following:

(a) The significant judgments and assumptions made by a reporting entity in determining whether it must do any of the following:

(b) Consolidate a variable interest entity (VIE)

(c) Disclose information about its involvement in a VIE.

(d) The nature of restrictions on a consolidated VIE’s assets and on the settlement of its liabilities reported by a reporting entity in its statement of financial position, including the carrying amounts of such assets and liabilities.

(e) The nature of, and changes in, the risks associated with a reporting entity’s involvement with the VIE.

(f) How a reporting entity’s involvement with the VIE affects the reporting entity’s financial position, financial performance, and cash flows.

50-2AB A reporting entity shall consider the overall objectives in the preceding paragraph in providing the disclosures required by this Subsection. To achieve those objectives, a reporting entity may need to supplement the disclosures otherwise required by this Subsection, depending on the facts and circumstances surrounding the VIE and a reporting entity’s interest in that VIE.
The disclosures required by this Subsection may be provided in more than one note to the financial statements, as long as the objectives in paragraph 810-10-50-2AA are met. If the disclosures are provided in more than one note to the financial statements, the reporting entity shall provide a cross reference to the other notes to the financial statements that provide the disclosures prescribed in this Subsection for similar entities.

9.3.10.20. The FASB decided that the disclosure objectives described in ASC paragraphs 810-10-50-2AA through 50-2AC were important to develop because it was not possible to develop specific disclosures that would anticipate all existing and future scenarios. Inclusion of these principles-based objectives in the disclosure guidance requires enterprises to exercise judgment when evaluating the overall adequacy of the disclosures made under ASC Section 810-10-50. If an enterprise’s involvement with, and associated risks from its involvement with, a VIE are not disclosed in a manner that would provide sufficient information to a financial statement user, additional disclosures should be made to provide the appropriate information.

9.3.10.30. There may be circumstances in which it will be difficult for enterprises to obtain, and for auditors to audit, the information necessary to comply with the ASC Topic 810 disclosure requirements on a timely basis. For example, enterprises may encounter difficulties in obtaining financial statements where they are not the legal owner or primary beneficiary of the VIE or where the VIE does not prepare financial statements or other reporting information. Given these potential challenges, enterprises that are variable interest holders should ascertain whether they have sufficient access to the financial information needed to prepare the ASC Topic 810 disclosures.

9.3.10.40. Certain public entities also must comply with the requirements of the Sarbanes-Oxley Act of 2002 to establish and maintain adequate internal controls over financial reporting, and to periodically report on the effectiveness of those controls. Based on comments made by the SEC staff at the 2009 AICPA National Conference on Current SEC and PCAOB Developments, it is our understanding that registrants that consolidate VIEs are expected to include those entities in managements’ reports on internal control over financial reporting (ICOFR). Because a registrant that consolidates a VIE does so because it controls the VIE, the SEC staff believes that the registrant likely has the right or authority to assess the internal controls of the consolidated VIE. The SEC staff stated that a rare exception to the inclusion of a VIE within managements’ reports on ICOFR may apply to consolidated VIEs that were in existence before December 15, 2003 for which the registrant does not possess the right or authority to assess the consolidated VIE’s internal controls and also lacks the ability to make that assessment. As a result, enterprises need to ensure that they have contractual rights and appropriate controls and procedures in place to obtain the necessary information.

information to both evaluate a consolidated VIE’s internal controls and comply with the disclosure requirements in ASC Topic 810.

9.3.20. Aggregation of VIE Disclosures

Excerpt from ASC Subtopic 810-10

Aggregation of Certain Disclosures

50-9 Disclosures about VIEs may be reported in the aggregate for similar entities if separate reporting would not provide more useful information to financial statement users. A reporting entity shall disclose how similar entities are aggregated and shall distinguish between:

(a) VIEs that are not consolidated because the reporting entity is not the primary beneficiary but has a variable interest

(b) VIEs that are consolidated.

In determining whether to aggregate VIEs, the reporting entity shall consider quantitative and qualitative information about the different risk and reward characteristics of each VIE and the significance of each VIE to the entity. The disclosures shall be presented in a manner that clearly explains to financial statement users the nature and extent of an entity’s involvement with VIEs.

50-10 A reporting entity shall determine, in light of the facts and circumstances, how much detail it shall provide to satisfy the requirements of the Variable Interest Entities Subsections. A reporting entity shall also determine how it aggregates information to display its overall involvements with VIEs with different risk characteristics. The reporting entity must strike a balance between obscuring important information as a result of too much aggregation and overburdening financial statements with excessive detail that may not assist financial statement users to understand the reporting entity's financial position. For example, a reporting entity shall not obscure important information by including it with a large amount of insignificant detail. Similarly, a reporting entity shall not disclose information that is so aggregated that it obscures important differences between the types of involvement or associated risks.

9.3.20.10. While disclosures about VIEs may be reported in the aggregate for similar entities if separate reporting would not provide more useful information, enterprises need to distinguish such disclosures between (1) non-consolidated VIEs and (2) consolidated VIEs.

9.3.20.20. Enterprises wishing to aggregate their VIE disclosures must ascertain which entities are similar for aggregation purposes. Management should consider qualitative factors relevant to the respective VIEs in making this determination. Examples include, but are not limited to:

- The VIEs’ purpose and design;
• The risks that the VIEs were designed to create and pass through to their variable interest holders;
• The level of the enterprise’s continuing involvement with the VIEs; and
• The composition of the VIEs’ balance sheets.

9.3.20.30. If taking an aggregation approach, enterprises must use judgment in determining how to aggregate information related to VIEs that they are involved with. In making this determination, enterprises should consider the needs of the financial statement users, including the level of disaggregation that would provide them with the most useful information. Aggregation is not permitted if disaggregated disclosures (separate presentation) would provide more meaningful information to financial statement users.

Question 9.3.20.1: Disclosures When Individually Insignificant Variable Interests Are in Aggregate Significant to the Enterprise

Is an enterprise with similar variable interests in multiple VIEs that do not result in consolidation and that individually are not significant required to comply with the disclosure requirements in ASC Topic 810 if the similar variable interests are significant to the enterprise in the aggregate?

Interpretive Response: Yes. We believe that the evaluation of significance should not be limited to consideration of individual variable interests, but also should consider whether similar variable interests when aggregated are significant to the enterprise. We believe significance should be evaluated primarily in relation to the enterprise. Therefore, individually insignificant variable interests should be disclosed if, when aggregated with similar variable interests in other VIEs, the aggregated variable interests are significant to the enterprise. We believe this is consistent with the notion of materiality discussed in FASB Concepts Statement No. 2, Qualitative Characteristics of Accounting Information, and SEC Staff Accounting Bulletin No. 99, Materiality.

If the reporting enterprise is an SEC registrant, SEC rules require disclosure in MD&A of all variable interests that “have, or are reasonably likely to have, a current or future effect on the registrant’s financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors” regardless of whether the variable interest is in an entity that meets the ASC Topic 810 definition of a VIE.2 The SEC rules further indicate that the definition of variable interest is intended to be consistent with the concept of a variable interest that is included in ASC Topic 810.

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9.3.30. Specific Disclosures of Consolidated and Non-Consolidated VIE Information

Excerpt from ASC Subtopic 810-10

Primary Beneficiary of a VIE

50-3 A VIE may issue voting equity interests, and the entity that holds a majority voting interest also may be the primary beneficiary of the VIE. If so, and if the VIE meets the definition of a business and the VIE’s assets can be used for purposes other than the settlement of the VIE’s obligations, the disclosures in paragraph 810-10-50-3(bb) through (d) are not required.

The primary beneficiary of a VIE that is a business shall provide the disclosures required by other guidance. The primary beneficiary of a VIE that is not a business shall disclose the amount of gain or loss recognized on the initial consolidation of the VIE. In addition to disclosures required elsewhere in this Topic, the primary beneficiary of a VIE shall disclose all of the following (unless the primary beneficiary also holds a majority voting interest):

(a) [Not Used]
(b) [Not Used]

(bb) The carrying amounts and classification of the VIE’s assets and liabilities in the statement of financial position that are consolidated in accordance with the Variable Interest Entities Subsections, including qualitative information about the relationship(s) between those assets and liabilities. For example, if the VIE’s assets can be used only to settle obligations of the VIE, the reporting entity shall disclose qualitative information about the nature of the restrictions on those assets.

(c) Lack of recourse if creditors (or beneficial interest holders) of a consolidated VIE have no recourse to the general credit of the primary beneficiary.

(d) Terms of arrangements, giving consideration to both explicit arrangements and implicit variable interests that could require the reporting entity to provide financial support (for example, liquidity arrangements and obligations to purchase assets) to the VIE, including events or circumstances that could expose the reporting entity to a loss.
Nonprimary Beneficiary Holder of a Variable Interest in a VIE

50-4 In addition to disclosures required by other guidance, a reporting entity that holds a variable interest in a VIE, but is not the VIE’s primary beneficiary, shall disclose:

(a) The carrying amounts and classification of the assets and liabilities in the reporting entity’s statement of financial position that relate to the reporting entity’s variable interest in the VIE.

(b) The reporting entity’s maximum exposure to loss as a result of its involvement with the VIE, including how the maximum exposure is determined and the significant sources of the reporting entity’s exposure to the VIE. If the reporting entity’s maximum exposure to loss as a result of its involvement with the VIE cannot be quantified, that fact shall be disclosed.

(c) A tabular comparison of the carrying amounts of the assets and liabilities, as required by (a) above, and the reporting entity’s maximum exposure to loss, as required by (b) above. A reporting entity shall provide qualitative and quantitative information to allow financial statement users to understand the differences between the two amounts. That discussion shall include, but is not limited to, the terms of arrangements, giving consideration to both explicit arrangements and implicit variable interests, that could require the reporting entity to provide financial support (for example, liquidity arrangements and obligations to purchase assets) to the VIE, including events or circumstances that could expose the reporting entity to a loss.

(d) Information about any liquidity arrangements, guarantees, and/or other commitments by third parties that may affect the fair value or risk of the reporting entity’s variable interest in the VIE is encouraged.

(e) If applicable, significant factors considered and judgments made in determining that the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance is shared in accordance with the guidance in paragraph 810-10-25-38D.

Primary Beneficiaries or Other Holders of Interests in VIEs

50-5A A reporting entity that is a primary beneficiary of a VIE or a reporting entity that holds a variable interest in a VIE but is not the entity’s primary beneficiary shall disclose all of the following:

(a) Its methodology for determining whether the reporting entity is the primary beneficiary of a VIE, including, but not limited to, significant judgments and assumptions made. One way to meet this disclosure requirement would be to provide information about the types of involvements a reporting entity considers significant, supplemented with
information about how the significant involvements were considered in determining whether the reporting entity is the primary beneficiary.

(b) If facts and circumstances change such that the conclusion to consolidate a VIE has changed in the most recent financial statements (for example, the VIE was previously consolidated and is not currently consolidated), the primary factors that caused the change and the effect on the reporting entity’s financial statements.

(c) Whether the reporting entity has provided financial or other support (explicitly or implicitly) during the periods presented to the VIE that it was not previously contractually required to provide or whether the reporting entity intends to provide that support, including both of the following:

(1) The type and amount of support, including situations in which the reporting entity assisted the VIE in obtaining another type of support

(2) The primary reasons for providing the support.

(d) Qualitative and quantitative information about the reporting entity’s involvement (giving consideration to both explicit arrangements and implicit variable interests) with the VIE, including, but not limited to, the nature, purpose, size, and activities of the VIE, including how the VIE is financed. Paragraphs 810-10-25-49 through 25-54 provide guidance on how to determine whether a reporting entity has an implicit variable interest in a VIE.

50-5B A VIE may issue voting equity interests, and the entity that holds a majority voting interest also may be the primary beneficiary of the VIE. If so, and if the VIE meets the definition of a business and the VIE’s assets can be used for purposes other than the settlement of the VIE’s obligations, the disclosures in the preceding paragraph are not required.

Scope-Related Disclosures

50-6 A reporting entity that does not apply the guidance in the Variable Interest Entities Subsections to one or more VIEs or potential VIEs because of the condition described in paragraph 810-10-15-17(c) shall disclose all the following information:

(a) The number of legal entities to which the guidance in the Variable Interest Entities Subsections is not being applied and the reason why the information required to apply this guidance is not available

(b) The nature, purpose, size (if available), and activities of the legal entities and the nature of the reporting entity’s involvement with the legal entities

(c) The reporting entity’s maximum exposure to loss because of its involvement with the legal entities

(d) The amount of income, expense, purchases, sales, or other measure of activity between the reporting entity and the legal entities for all periods
presented. However, if it is not practicable to present that information for prior periods that are presented in the first set of financial statements for which this requirement applies, the information for those prior periods is not required.

### 9.3.30.10

The principal disclosures for consolidated and non-consolidated VIEs and their applicability are summarized as follows:

<table>
<thead>
<tr>
<th>Information Required to Be Disclosed</th>
<th>Primary Beneficiary</th>
<th>Other Variable Interest Holder</th>
</tr>
</thead>
<tbody>
<tr>
<td>Methodology (including significant judgments and assumptions) for determining whether the enterprise is the primary beneficiary of a VIE</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>If applicable, the primary factors that caused a change in the enterprise’s primary beneficiary status and the effect on its financial statements</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>If the enterprise has provided explicit or implicit support to the VIE that was not previously contractually required or whether the enterprise intends to provide such support, including the type, amount, and primary reasons for providing the support</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Qualitative and quantitative information about the enterprise’s explicit and implicit involvement with the VIE, including, but not limited to, the nature, purpose, size, and activities of the VIE, including how the VIE is financed</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>The carrying amounts and classification of the assets and liabilities in the enterprise’s balance sheet that relate to its variable interest(s) in the VIE</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>The enterprise’s maximum exposure to loss as a result of its involvement with the VIE, including how it is determined and the significant sources of exposure to the VIE</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Information Required to Be Disclosed</td>
<td>Primary Beneficiary</td>
<td>Other Variable Interest Holder</td>
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<td>-------------------------------------</td>
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</tr>
<tr>
<td>A tabular comparison of the carrying amounts of the VIE’s assets and liabilities and the enterprise’s maximum exposure to loss from both explicit and implicit variable interests, including qualitative and quantitative information about differences between the two amounts</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Information about any liquidity arrangements, guarantees, and/or other commitments by third parties that may affect the fair value or risk of the enterprise’s variable interest(s)</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>If applicable, significant factors considered and judgments made in determining that the power to direct the activities that most significantly impact the VIE’s economic performance is shared</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Gain or loss recognized on the initial consolidation of the VIE</td>
<td>X (if VIE is not a business)</td>
<td></td>
</tr>
<tr>
<td>The carrying amounts and classification of the VIE’s assets and liabilities that are consolidated in the balance sheet</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Lack of recourse if creditors (or beneficial interest holders) of a consolidated VIE have no recourse to the general credit of the primary beneficiary</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Terms of arrangements that could require the enterprise to provide financial support to the VIE, including events or circumstances that could expose the enterprise to a loss</td>
<td></td>
<td>X</td>
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</tbody>
</table>
**Question 9.3.30.1: Disclosure of a Non-Primary Beneficiary’s Maximum Exposure to Loss**

ASC subparagraph 810-10-50-4(b) requires an enterprise that holds a variable interest in a VIE, but is not the VIE’s primary beneficiary, to disclose its maximum exposure to loss as a result of its involvement with the VIE. How should maximum exposure to loss be interpreted for this disclosure requirement?

**Interpretive Response:** An enterprise’s *maximum exposure to loss* represents the maximum loss that could potentially be recorded through earnings in future periods as a result of its explicit or implicit variable interest in a VIE, regardless of the probability of the losses actually occurring. Enterprises should consider future funding commitments (e.g., capital call requirements, etc.) and other potential costs in addition to their existing variable interests when determining the maximum loss amount.

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**9.3.40. Common Control Leasing Arrangements for a Private Company**

**Excerpt from ASC Subtopic 810-10**

**Accounting Alternatives**

**50-2AD** A private company lessee that does not apply the requirements of the Variable Interest Entities Subsections to one or more lessor legal entities because it meets the criteria in paragraph 810-10-15-17A shall disclose the following:

(a) The amount and key terms of liabilities (for example, debt, environmental liabilities, and asset retirement obligations) recognized by the lessor legal entity that expose the private company lessee to providing financial support to the legal entity. For example, a private company lessee exposed to debt of the legal entity should disclose information such as the amount of debt, interest rate, maturity, pledged collateral, and guarantees associated with the debt.

(b) A qualitative description of circumstances (for example, certain commitments and contingencies) not recognized in the financial statements of the lessor legal entity that expose the private company lessee to providing financial support to the legal entity.

**50-2AE** In applying the disclosure guidance in paragraph 810-10-50-2AD, a private company lessee shall consider exposures through implicit guarantees. The determination as to whether an implicit guarantee exists is based on facts and circumstances. Those facts and circumstances include, but are not limited to, whether:
(a) There is an economic incentive for the private company lessee to act as a guarantor or to make funds available.

(b) Such actions have happened in similar situations in the past.

(c) The private company lessee acting as a guarantor or making funds available would be considered a conflict of interest or illegal.

50-2AF In disclosing information about the lessor legal entity, a private company lessee shall present the disclosures in combination with the disclosures required by other guidance (for example, in Topics 460 on guarantees, 850 on related party disclosures, and 840 on leases). Those disclosures could be combined in a single note or by including cross-references within the notes to financial statements.

9.3.40.10. If a private company lessee applies the common control leasing arrangements alternative described in Subsection 2.4, the following disclosures must be provided:

- Amount and key terms of liabilities (e.g., debt, environmental liabilities, and asset retirement obligations) recognized by the lessor that expose the private company to providing financial support to the lessor. For example, a private company lessee exposed to debt of the lessor should disclose information such as the amount of debt, interest rate, maturity, pledged collateral, and guarantees associated with the debt.

- A qualitative description of circumstances (e.g., certain commitments and contingencies) not recognized in the financial statements of the lessor that expose the private company to providing financial support to the lessor.

9.3.40.20. When providing the above disclosures, a private company should consider both explicit and implicit guarantees. The determination of whether an implicit guarantee exists is based on facts and circumstances. ASC paragraph 810-10-50-2AE provides example facts and circumstances that affect the determination of whether an implicit guarantee exists:

- There is an economic incentive for the private company lessee to act as a guarantor or to make funds available.
- Such actions have happened in similar situations in the past.
- The private company lessee acting as a guarantor or making funds available would be considered a conflict of interest or illegal.

9.3.40.30. The above facts and circumstances are not all inclusive. See Subsection 3.3 for a broader discussion of implicit variable interests.
9.3.50. Collateralized Financing Entities

Excerpt from ASC Subtopic 810-10

50-20 A reporting entity that consolidates a collateralized financing entity and measures the financial assets and the financial liabilities using the measurement alternative in paragraphs 810-10-30-10 through 30-15 and 810-10-35-6 through 35-8 shall disclose the information required by Topic 820 on fair value measurement and Topic 825 on financial instruments for the financial assets and the financial liabilities of the consolidated collateralized financing entity.

50-21 For the less observable of the fair value of the financial assets and the fair value of the financial liabilities of the collateralized financing entity that is measured in accordance with the measurement alternative in paragraphs 810-10-30-10 through 30-15 and 810-10-35-6 through 35-8, a reporting entity shall disclose that the amount was measured on the basis of the more observable of the fair value of the financial liabilities and the fair value of the financial assets.

50-22 The disclosures in paragraphs 810-10-50-20 through 50-21 do not apply to the financial assets and the financial liabilities that are incidental to the operations of the collateralized financing entity and have carrying values that approximate fair value.

9.3.50.10. FASB Accounting Standards Update No. 2014-13 (ASU 2014-13), Measuring the Financial Assets and the Financial Liabilities of a Consolidated Collateralized Financing Entity, allows an alternative fair value measurement approach for certain consolidated CFEs. The approach permits the parent of a consolidated CFE to measure the CFE’s financial assets and liabilities based on either the fair value of the financial assets or financial liabilities, whichever has the more observable inputs. When a reporting enterprise elects this measurement alternative to a consolidated CFE, it should disclose the information described in ASC paragraphs 810-10-50-20 through 50-22. See Section 8, Initial Measurement and Subsequent Accounting for a Consolidated VIE, for additional guidance on the application of ASU 2014-13’s measurement alternative.
10. Effective Date and Transition

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10.4. ASU 2017-02, Clarifying When a Not-for-Profit Entity That is a General Partner or a Limited Partner Should Consolidate a For-Profit Limited Partnership or Similar Entity
Excerpt from ASC Subtopic 810-10

Transition Related to Accounting Standards Update No. 2015-02, Consolidation (Topic 810): Amendments to the Consolidation Analysis

65-7 The following represents the transition and effective date information related to Accounting Standards Update No. 2015-02, Consolidation (Topic 810): Amendments to the Consolidation Analysis:

(a) The pending content that links to this paragraph shall be effective as follows:

(1) For **public business entities**, for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2015.

(2) For all other entities, for fiscal years beginning after December 15, 2016, and for interim periods within fiscal years beginning after December 15, 2017.

(b) If a reporting entity is required to consolidate a **legal entity** as a result of the initial application of the pending content that links to this paragraph, the initial measurement of the assets, liabilities, and noncontrolling interests of the legal entity depends on whether the determination of their carrying amounts is practicable. In this context, carrying amounts refers to the amounts at which the assets, liabilities, and noncontrolling interests would have been carried in the consolidated financial statements if the requirements of the pending content that links to this paragraph had been effective when the reporting entity first met the conditions to consolidate the legal entity.

(1) If determining the carrying amounts is practicable, the reporting entity shall initially measure the assets, liabilities, and noncontrolling interests of the legal entity at their carrying amounts at the date the pending content that links to this paragraph first applies.

(2) If determining the carrying amounts is not practicable, the assets, liabilities, and noncontrolling interests of the legal entity shall be measured at fair value at the date the pending content that links to this paragraph first applies.

(c) Any difference between the net amount added to the statement of financial position of the reporting entity and the amount of any previously recognized interest in the newly consolidated legal entity shall be recognized as a cumulative-effect adjustment to retained earnings. A reporting entity shall describe the transition method(s) applied and shall disclose the amount and classification in its statement of financial position of the consolidated assets or liabilities by the transition method(s) applied.
(d) A reporting entity that is required to consolidate a legal entity as a result of the initial application of the pending content that links to this paragraph may elect the fair value option provided by the Fair Value Option Subsections of Subtopic 825-10 on financial instruments, but only if the reporting entity elects the option for all financial assets and financial liabilities of that legal entity that are eligible for this option under those Fair Value Option Subsections. This election shall be made on a legal entity-by-legal entity basis. Along with the disclosures required in those Fair Value Option Subsections, the reporting entity shall disclose all of the following:

(1) Management’s reasons for electing the fair value option for a particular legal entity or group of legal entities.

(2) The reasons for different elections if the fair value option is elected for some legal entities and not others.

(3) Quantitative information by line item in the statement of financial position indicating the related effect on the cumulative-effect adjustment to retained earnings of electing the fair value option for a legal entity.

(e) If a reporting entity is required to deconsolidate a legal entity as a result of the initial application of the pending content that links to this paragraph, the initial measurement of any retained interest in the deconsolidated former subsidiary depends on whether the determination of its carrying amount is practicable. In this context, carrying amount refers to the amount at which any retained interest would have been carried in the reporting entity’s financial statements if the pending content that links to this paragraph had been effective when the reporting entity became involved with the legal entity or no longer met the conditions to consolidate the legal entity.

(1) If determining the carrying amount is practicable, the reporting entity shall initially measure any retained interest in the deconsolidated former subsidiary at its carrying amount at the date the pending content that links to this paragraph first applies.

(2) If determining the carrying amount is not practicable, any retained interest in the deconsolidated former subsidiary shall be measured at fair value at the date the pending content that links to this paragraph first applies.

(f) Any difference between the net amount removed from the statement of financial position of the reporting entity and the amount of any retained interest in the newly deconsolidated legal entity shall be recognized as a cumulative-effect adjustment to retained earnings. A reporting entity shall disclose the amount of any cumulative-effect
adjustment related to deconsolidation separately from any cumulative-effect adjustment related to consolidation of entities.

(g) The determinations of whether a legal entity is a variable interest entity (VIE) and which reporting entity, if any, should consolidate the legal entity shall be made as of the date the reporting entity became involved with the legal entity or, if events have occurred requiring reconsideration of whether the legal entity is a VIE and which reporting entity, if any, should consolidate the legal entity, as of the most recent date at which the pending content that links to this paragraph would have required consideration.

(h) If, at transition, it is not practicable for a reporting entity to obtain the information necessary to make the determinations in (g) as of the date the reporting entity became involved with a legal entity or at the most recent reconsideration date, the reporting entity shall make the determinations as of the date on which the pending content that links to this paragraph is first applied.

(i) If the determinations of whether a legal entity is a VIE and whether a reporting entity should consolidate the legal entity are made in accordance with (h), then the consolidating entity shall measure the assets, liabilities, and noncontrolling interests of the legal entity at fair value as of the date on which the pending content that links to this paragraph is first applied.

(j) The pending content that links to this paragraph may be applied retrospectively in previously issued financial statements for one or more years with a cumulative-effect adjustment to retained earnings as of the beginning of the first year restated.

(k) Early adoption, including adoption in an interim period, of the pending content that links to this paragraph is permitted. If an entity early adopts the pending content that links to this paragraph in an interim period, any adjustments (see paragraph 810-10-65-7(b) through (i)) shall be reflected as of the beginning of the fiscal year that includes that interim period.

(l) An entity shall provide the disclosures in paragraphs 250-10-50-1 through 50-2 (with the exception of the disclosure in paragraph 250-10-50-1(b)(2)) in the period the entity adopts the pending content that links to this paragraph.

Transition Related to FASB Statement No. 167, Amendments to FASB Interpretation No. 46(R) [relevant paragraphs only]

Initial Consolidation when Earlier Consolidation Was Prevented Due to Lack of Information

30-7 A reporting entity that has not applied the Variable Interest Entities Subsections to a legal entity because of the condition described in paragraph 810-10-15-17(c) and that subsequently obtains the information necessary to
apply the Variable Interest Entities Subsections to that entity shall apply the provisions of the Variable Interest Entities Subsections as of the date the information is acquired in accordance with the following paragraph.

30-8 The initial measurement by a consolidating entity of the assets, liabilities, and noncontrolling interests of the VIE at the date the requirements of the Variable Interest Entities Subsections first apply depends on whether the determination of their carrying amounts is practicable. In this context, *carrying amounts* refers to the amounts at which the assets, liabilities, and noncontrolling interests would have been carried in the consolidated financial statements if the Variable Interest Entities Subsections had been effective when the reporting entity first met the conditions to be the primary beneficiary.

30-8A If determining the carrying amounts is practicable, the consolidating entity shall initially measure the assets, liabilities, and noncontrolling interests of the VIE at their carrying amounts at the date the Variable Interest Entities Subsections first apply.

30-8B If determining the carrying amounts is not practicable, the assets, liabilities, and noncontrolling interests of the VIE shall be measured at fair value at the date the Variable Interest Entities Subsections first apply. However, as an alternative to this fair value measurement requirement, the assets and liabilities of the VIE may be measured at their unpaid principal balances at the date the Variable Interest Entities Subsections first apply if both of the following conditions are met:

(a) The activities of the VIE are primarily related to securitizations or other forms of asset-backed financings.

(b) The assets of the VIE can be used only to settle obligations of the entity.

30-8C The measurement alternative in the preceding paragraph does not obviate the need for the primary beneficiary to recognize any accrued interest, an allowance for credit losses, or other-than-temporary impairment, as appropriate. Other assets, liabilities, or noncontrolling interests, if any, that do not have an unpaid principal balance, and any items that are required to be carried at fair value under other applicable standards, shall be measured at fair value.

30-8D Any difference between the net amount added to the balance sheet of the consolidating entity and the amount of any previously recognized interest in the newly consolidated VIE shall be recognized as a cumulative-effect adjustment to retained earnings.

30-9 The Variable Interest Entities Subsections may be applied retrospectively in previously issued financial statements for one or more years with a cumulative-effect adjustment to retained earnings as of the beginning of the first year restated.
The following represents the transition and effective date information related to Accounting Standards Update No. 2014-13, Consolidation (Topic 810): Measuring the Financial Assets and the Financial Liabilities of a Consolidated Collateralized Financing Entity:

(a) The pending content that links to this paragraph shall be effective as follows:

(1) For public business entities, for annual periods, and interim periods within those annual periods, beginning after December 15, 2015

(2) For all other entities, for annual periods ending after December 15, 2016, and interim periods beginning after December 15, 2016.

(b) Upon adoption, a reporting entity may apply the measurement alternative in paragraphs 810-10-30-10 through 30-15 and 810-10-35-6 through 35-8 to any existing consolidated collateralized financing entity that meets the scope requirements of paragraph 810-10-15-17D using a modified retrospective approach by remeasuring the financial assets or the financial liabilities of the existing consolidated collateralized financing entity as of the beginning of the annual period of adoption and recording a cumulative-effect adjustment for the remeasurement to equity. Any reporting entity that does not elect to apply the measurement alternative shall reclassify any accumulated differences in the fair value of the financial assets and the fair value of the financial liabilities of its collateralized financing entity to retained earnings if those differences were previously presented in another caption within equity (for example, appropriated retained earnings).

(c) A reporting entity also may elect to apply the pending content that links to this paragraph retrospectively to all relevant prior periods beginning with the annual period in which the amendments in Accounting Standards Update No. 2009-17, Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities, were initially adopted.

(d) A reporting entity that consolidates a collateralized financing entity that does not meet the scope requirements in paragraph 810-10-15-17D because the fair value option in Topic 825 was not elected to measure the eligible financial assets, financial liabilities, or both of the collateralized financing entity when it was initially consolidated, may elect at the date of adoption to apply the measurement alternative in paragraphs 810-10-30-10 through 30-15 and 810-10-
35-6 through 35-8 to those financial assets and financial liabilities or to continue using the guidance in other Topics to measure the financial assets and the financial liabilities of the consolidated collateralized financing entity. A reporting entity that does not elect to use the measurement alternative may not elect at the date of adoption to use the measurement requirements of Topic 820 on fair value measurement or to otherwise change its basis for measuring the financial assets or the financial liabilities of the collateralized financing entity.

(e) Earlier application of the pending content that links to this paragraph is permitted as of the beginning of an annual period.

(f) An entity shall provide the disclosures in paragraphs 250-10-50-1 through 50-3 in the period the entity adopts the pending content that links to this paragraph.

10.1. EFFECTIVE DATE

10.1.10.10. FASB Accounting Standards Update No. 2015-02 (ASU 2015-02), Amendments to the Consolidation Analysis, was effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2015. For all other entities, the guidance is effective for annual periods in fiscal years beginning after December 15, 2016, and for interim periods in fiscal years beginning after December 15, 2017. Early adoption is permitted, including early adoption in an interim period. If a reporting enterprise chooses to early adopt in an interim period, adjustments resulting from the revised consolidation analyses must be determined as of the beginning of the fiscal year that includes that interim period.

10.1.10.20. The guidance within ASU 2015-02 applies to all entities that a reporting enterprise is involved with, regardless of whether that involvement began before ASU 2015-02’s effective date. Accordingly, after the effective date of the ASU, reporting enterprises must reconsider the VIE status and primary beneficiary assessments for all entities that they are involved with.

Question 10.1.1: Early Adoption

Is a reporting enterprise permitted to early adopt ASU 2015-02?

Interpretive Response: Yes. Early adoption of the ASU is permitted in an interim or annual period. The FASB decided to permit early adoption, including adoption in an interim period, to eliminate existing complexity in practice as soon as practicable. Reporting enterprises will need to ensure that they have appropriately evaluated all entities with which they have involvement to determine whether there are changes in previous consolidation and/or disclosure conclusions before initially applying the ASU’s requirements. In addition, reporting enterprises will need to evaluate their existing processes.
Consolidation of Variable Interest Entities, Section 10

Question 10.1.2: Reporting the Effects of Early Adoption

If a reporting enterprise elects to early adopt ASU 2015-02, how should the effects of adoption be reported?

Interpretive Response: If a reporting enterprise elects to early adopt the ASU, any required adjustments to assets, liabilities, and noncontrolling interests along with the cumulative-effect adjustment to equity (if any) are made as of the beginning of the fiscal year of adoption.

For example, assume a calendar-year-end private company deconsolidates an investee upon adoption of the ASU and accounts for its retained interest in the investee under the equity method of accounting. The reporting enterprise may decide to early adopt the ASU for calendar year 2016 if financial statements for calendar year 2016 have not been issued. If it is not practicable for the reporting enterprise to determine the carrying amount of its retained interest in the investee (which is discussed later in this section), the reporting enterprise measures its retained interest in the investee at fair value as of January 1, 2016. The difference between the net amounts removed from the statement of financial position and the fair value of the reporting enterprise’s retained interest in the investee is recognized as a cumulative-effect adjustment to retained earnings as of January 1, 2016. The reporting enterprise recognizes its share of the investee’s earnings or losses under the equity method in its income statement for the period from January 1, 2016 through December 31, 2016 and adjusts the carrying amount of the investee at December 31, 2016 accordingly.

In the period of adoption, the reporting enterprise must provide the following disclosures for a change in accounting principle:

Excerpt from ASC Topic 250-10

50-1 An entity shall disclose all of the following in the fiscal period in which a change in accounting principle is made:

(a) The nature of and reason for the change in accounting principle, including an explanation of why the newly adopted accounting principle is preferable.

(b) The method of applying the change, including all of the following:

1) A description of the prior-period information that has been retrospectively adjusted, if any.

3) The cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of
4) If retrospective application to all prior periods is impracticable, disclosure of the reasons therefore, and a description of the alternative method used to report the change (see paragraphs 250-10-45-5 through 45-7).

(c) If indirect effects of a change in accounting principle are recognized both of the following shall be disclosed:

(1) A description of the indirect effects of a change in accounting principle, including the amounts that have been recognized in the current period, and the related per-share amounts, if applicable.

(2) Unless impracticable, the amount of the total recognized indirect effects of the accounting change and the related per-share amounts, if applicable, that are attributable to each prior period presented. Compliance with this disclosure requirement is practicable unless an entity cannot comply with it after making every reasonable effort to do so.

Financial statements of subsequent periods need not repeat the disclosures required by this paragraph. If a change in accounting principle has no material effect in the period of change but is reasonably certain to have a material effect in later periods, the disclosures required by (a) shall be provided whenever the financial statements of the period of change are presented.

50-2 An entity that issues interim financial statements shall provide the required disclosures in the financial statements of both the interim period of the change and the annual period of the change.

A reporting enterprise is permitted, but not required, to apply ASU 2015-02’s guidance retrospectively in previously issued financial statements for one or more years with a cumulative-effect adjustment to retained earnings as of the beginning of the first year restated.

10.2. TRANSITION PROVISIONS

10.2.10. Entity Identification and Recognition

10.2.10.10. Upon the effective date of ASU 2015-02, reporting enterprises may be required to consolidate VIEs that were not previously consolidated or to deconsolidate entities that were previously required to be consolidated before the ASU’s effective date. ASC subparagraph 810-10-65-7(g) requires reporting enterprises to determine the effect of applying ASU 2015-02 by assuming its provisions had always been effective. This includes determining whether an
entity is a VIE and which reporting enterprise, if any, is the VIE’s primary beneficiary at the later of (1) the date that the reporting enterprise initially became involved with the entity or (2) the date that events requiring reconsideration of the entity’s or variable interest holders’ status have occurred. Only those VIEs for which the reporting enterprise has concluded that it is the primary beneficiary as of the effective date of ASU 2015-02 should be consolidated at that date. While the adoption of ASU 2015-02 may occasionally result in a conclusion that a previously unconsolidated entity needs to be consolidated, it is much more likely that entities that were previously consolidated will be deconsolidated on initial application of the ASU.

**Question 10.2.10.1: Consideration of a VIE’s Designated Hedging Relationships upon Consolidation**

Should hedging transactions that were documented by a VIE under the requirements of ASC Topic 815, Derivatives and Hedging, be redesignated upon initial consolidation of the VIE by the primary beneficiary on initial application of ASU 2015-02?

**Interpretive Response:** We believe that hedging transactions documented by a VIE under the requirements of ASC Topic 815 before the effective date of ASU 2015-02 need not be redesignated on initial application. For those transactions, the primary beneficiary should include the effects of hedge accounting within the VIE in measuring the cumulative effect of adoption (i.e., adjustments to the amounts of assets, liabilities, and accumulated other comprehensive income as a result of hedge accounting would be retained on initial consolidation of the variable interest entity by the primary beneficiary).

If a primary beneficiary wishes to prospectively apply hedge accounting to certain transactions within a consolidated VIE and the hedging documentation requirements of ASC Topic 815 were not met for those transactions before initial consolidation of the entity upon initial application of ASU 2015-02, the primary beneficiary would be required to designate and document those hedging transactions under the requirements of ASC Topic 815 on initial application of ASU 2015-02.

**PRACTICABILITY EXCEPTION**

**10.2.10.20.** In certain situations, it may not be practicable for a reporting enterprise to determine whether an entity was a VIE or the enterprise’s primary beneficiary status as of the date of initial involvement with the entity or subsequent reconsideration, assuming that the provisions of ASU 2015-02 were always effective. If at transition it is not practicable for a reporting enterprise to obtain the information necessary to perform this evaluation on the date that the reporting enterprise became involved with the entity or date of reconsideration, ASC subparagraph 810-10-65-7(h) indicates that the reporting enterprise should determine an entity’s VIE status and the enterprise’s primary beneficiary status on the date that ASU 2015-02 is first applied.
**Question 10.2.10.2: Date to Be Used for VIE and Primary Beneficiary Analyses on Initial Application of ASU 2015-02**

Should a reporting enterprise determine (1) whether an entity is a variable interest entity and (2) which enterprise, if any, is a VIE’s primary beneficiary as of the date of initial application of ASU 2015-02 or as of the date the reporting enterprise first became involved with the VIE?

**Interpretive Response:** ASC subparagraph 810-10-65-7(g) indicates that both determinations should be made as of the date the reporting enterprise became involved with the entity unless events that require reconsideration of the entity’s status or the status of its variable interest holders have occurred subsequently. If a reconsideration event has occurred, each determination should be made as of the most recent date at which ASC Subtopic 810-10, *Consolidation – Overall*, would have required reconsideration.

However, ASC subparagraph 810-10-65-7(h) also indicates that if, at transition, it is not practicable for an enterprise to obtain the information necessary to make the determinations as of the date the enterprise became involved with an entity or at the most recent reconsideration date, the enterprise should make the determinations as of the date on which ASU 2015-02 is first applied. In that scenario, the primary beneficiary should measure the assets, liabilities, and noncontrolling interests of the VIE at fair value as of the date on which ASU 2015-02 is first applied.

We believe that a reporting enterprise’s transition analysis of whether entities it is involved with that were created before the effective date of ASU 2015-02 are VIEs and whether the reporting enterprise is the primary beneficiary of any of those entities should be performed as follows, assuming that the reporting enterprise is not retrospectively applying ASU 2015-02:

1. The reporting enterprise should ascertain the population of entities (see ASC paragraph 810-10-15-14 for the definition of a variable interest entity) it is involved with as of the effective date of ASU 2015-02.

2. The reporting enterprise should determine the date that it first became involved with a particular entity within the population of entities identified in Step 1.

3. The reporting enterprise should determine whether, after the date that it first became involved with the entity and up until the date of initial application of ASU 2015-02, there have been any triggering events under ASC paragraph 810-10-35-4 that require a reassessment of whether the entity is a VIE.

4. The reporting enterprise should determine whether the entity was a VIE at the later of the date that it first became involved with the entity or the most recent triggering event identified in Step 3.
(5) If the reporting enterprise determines in Step 4 that the entity was a VIE, the reporting enterprise should determine whether, after the date that the entity was determined to be a VIE, there have been any triggering events as discussed in Subsection 6.6 that require a primary beneficiary reassessment.

(6) The reporting enterprise should determine whether it was the primary beneficiary of the entity at the later of the date that the entity was determined to be a VIE (Step 3) or the most recent triggering event identified in Step 5.

(7) If the reporting enterprise determines as a result of applying the previous steps that:

(a) It is the entity’s primary beneficiary at the date of initial application, it should apply the guidance in ASC subparagraph 810-10-65-7(b) about initial measurement and accounting after initial measurement for the assets, liabilities, and noncontrolling interests of the consolidated entity beginning as of the date that the reporting enterprise determines that it became the entity’s primary beneficiary in Step 6, through the date of initial application, to determine what the carrying amounts of those assets, liabilities, and noncontrolling interests would have been, had ASU 2015-02 been in effect when the reporting enterprise became the entity’s primary beneficiary.

(b) It is required to deconsolidate the entity, it should apply the guidance in ASC subparagraph 810-10-65-7(e) about initial measurement of any retained interest in the deconsolidated former subsidiary beginning as of the date that the reporting enterprise determines that it became involved with the entity, or no longer met the conditions to consolidate the entity, in Step 6, through the date of initial application, to determine what the carrying amounts of the retained interest would have been, had ASU 2015-02 been in effect when the reporting enterprise became involved with the entity, or no longer met the conditions to consolidate the entity.

(8) When a reporting enterprise is required to:

(a) Consolidate an entity at the initial application of ASU 2015-02, the cumulative-effect adjustment should be calculated as the difference between the carrying amount of the reporting enterprise’s previously recognized interest in the entity and the net asset carrying amount determined in Step 7(a).

(b) Deconsolidate an entity at the initial application of ASU 2015-02, the cumulative-effect adjustment should be calculated as the difference between the net amount removed from the
statement of financial position and the amount of any retained interest in the newly deconsolidated legal entity determined in Step 7(b).

10.2.20. Measurement upon Consolidation after Initial Application of ASU 2015-02

10.2.20.10. If a reporting enterprise is required to consolidate a VIE as a result of the initial application of ASU 2015-02, ASC subparagraph 810-10-65-7(b) requires the enterprise to initially measure the assets, liabilities, and noncontrolling interests of the consolidated VIE at their carrying amounts if determining their carrying amounts is practicable. Carrying amounts refer to the amounts at which the assets, liabilities, and noncontrolling interests would have been carried in the consolidated financial statements if the requirements of ASU 2015-02 had been effective when the reporting enterprise first met the conditions to be the primary beneficiary. Any difference between the net amount added to the balance sheet of the reporting enterprise upon consolidation and the previously recognized interest in the VIE should be recognized as a cumulative-effect adjustment to retained earnings under ASC subparagraph 810-10-65-7(c).

Question 10.2.20.1: Carrying Amount Measurement Considerations

If a reporting enterprise is required to consolidate a VIE as a result of its initial application of ASU 2015-02, how should an enterprise initially measure the carrying amounts of the assets, liabilities, and noncontrolling interests of the VIE?

Interpretive Response: As stated in paragraph 10.2.20.10, carrying amounts refer to the amounts at which the assets, liabilities, and noncontrolling interests would have been carried in the consolidated financial statements if ASU 2015-02 had been effective when the enterprise first met the conditions of ASU 2015-02 to be the primary beneficiary of the VIE.

An enterprise should consider accounting standards in effect at the date the initial carrying amount of an entity consolidated as a result of the initial application of ASU 2015-02 is measured, and the effects of accounting standards that were adopted after that date, when initially measuring the assets, liabilities, and noncontrolling interests of VIEs consolidated as a result of ASU 2015-02. We believe that an enterprise may elect to make an accounting policy choice of whether or not to apply the guidance in ASC Topic 805, Business Combinations, and ASC Subtopic 810-10 (formerly FASB Statement No. 160, Noncontrolling Interests in Consolidated Financial Statements) to determine the initial carrying amount of the assets, liabilities, and noncontrolling interests of VIEs that first met the conditions of ASU 2015-02 to be consolidated by the enterprise before the effective date of the guidance in ASC Topic 805 and ASC Subtopic 810-10. If an enterprise elects not to apply that guidance before those effective dates, we believe the
enterprise should apply the measurement guidance in unamended ASC Subtopic 810-10 instead.

Assuming the date that an enterprise would have become the primary beneficiary of a VIE had ASU 2015-02 always been effective falls before the ASU’s effective date, there is no clear guidance about how to account for amounts that would have been recorded in accumulated other comprehensive income (AOCI) under U.S. GAAP by the newly-consolidated VIE before the ASU’s effective date. Newly-consolidated VIEs may have amounts recorded in AOCI related to gains/losses on available-for-sale securities, the effective portion of gains/losses associated with derivative instruments designated as cash flow hedges, and amounts recorded in foreign currency cumulative translation adjustments. We believe it would be appropriate for those amounts to be recorded as AOCI of the primary beneficiary on initial application of ASU 2015-02. Consider the following example:

An enterprise consolidates a VIE as of January 1, 2016 (the date it adopts ASU 2015-02) and would have become the primary beneficiary of that VIE three years before the effective date (i.e., January 1, 2013) if ASU 2015-02 had always been effective.

To determine the VIE’s carrying amounts at January 1, 2016, the enterprise should determine what the fair values of the VIE’s assets, liabilities, and noncontrolling interests would have been as of January 1, 2013 and apply U.S. GAAP to determine what the carrying amounts of those assets, liabilities, and noncontrolling interests would be at January 1, 2016 based on their initial fair value measurement as of January 1, 2013. This should include amounts that would be recorded as AOCI between January 1, 2013 and January 1, 2016.

The primary beneficiary should apply reasonable judgment to determine what the VIE’s intent (e.g., related to classification of investment securities) would have been during the period from January 1, 2013 to January 1, 2016 in applying U.S. GAAP to determine what amounts would be recorded in AOCI of the newly-consolidated VIE on initial application of ASU 2015-02.

In addition, if an enterprise is required to discontinue a pre-existing hedging relationship on the initial application of ASU 2015-02 due to the required consolidation of a VIE in, or the deconsolidation of that VIE from, the reporting enterprise’s consolidated financial statements, the adjustments of the reporting enterprise’s financial statements should reflect the ongoing effect of the previous hedge accounting for those discontinued hedging relationships in a manner consistent with its risk management policy and the objectives of those discontinued hedging relationships. In these circumstances, the guidance previously provided in DIG Issue E22, “Hedging-General: Accounting for the Discontinuance of Hedging Relationships Arising from Changes in Consolidation Practices Related to Applying FASB Interpretation No. 46 or 46(R)” while not codified, should be followed.
Question 10.2.20.2: Effect of Reconsideration Events on the Initial Measurement of a VIE

Background: A VIE is created on January 1, 20X3 to hold a portfolio of asset-backed securities. The VIE is financed with equity from two investors: Manager A (5%) and Investor B (95%). Investor B owns 25% of Manager A’s equity. Manager A is the asset manager of the VIE and for its services, earns base, fixed-senior and subordinated fees, and a performance-based fee in which it receives a portion of the VIE’s profits above a targeted return. The fees are considered commensurate with the services provided and only include customary terms and conditions. Manager A has the power to direct the activities that most significantly impact the VIE’s economic performance. Investor B does not have the right to remove Manager A as the asset manager without cause and does not have any other rights to participate in the decisions about the VIE’s activities.

Investor B determines that it would be the primary beneficiary of the VIE at the inception of the entity under the requirements of ASU 2015-02 because:

- The VIE has a single decision maker (Manager A),
- Manager A is part of a group of related parties with Investor B that are not under common control and that collectively meets the criteria to be considered the VIE’s primary beneficiary, and
- Substantially all of the VIE’s activities are conducted on behalf of Investor B.
On December 31, 20X4, a reconsideration event occurred as a result of a change in the VIE’s governing documents. However, Investor B was still the primary beneficiary of the VIE following this reconsideration event.

**Question A:** Does the reconsideration event described above affect the initial measurement of the VIE upon the initial application of ASU 2015-02?

**Interpretive Response:** As stated in ASC subparagraph 810-10-65-7(g), the determination of whether a legal entity is a VIE and which reporting enterprise, if any, is a VIE’s primary beneficiary should be made at the date the reporting enterprise first became involved with the legal entity or the most recent date at which a reconsideration event has occurred. In this example, Investor B is the primary beneficiary at the inception of the VIE and following the reconsideration event. Accordingly, this reconsideration event would not result in any adjustment to the assets, liabilities, or noncontrolling interests of the VIE.

**Question B:** How would the response to Question A change assuming the same facts as described above, except that Investor B was not the primary beneficiary upon inception of the entity (January 1, 20X3) and that the reconsideration event that occurred on December 31, 20X4 resulted in Investor B becoming the primary beneficiary under ASU 2015-02?

**Interpretive Response:** Given this change in the fact pattern, Investor B would be required to determine the carrying amounts upon the initial application of ASU 2015-02 at the time of consolidation (December 31, 20X4). That is, Company X’s initial measurement of the VIE’s assets, liabilities, and noncontrolling interests would be determined at December 31, 20X4 and rolled forward to January 1, 2016 to arrive at the carrying amounts at the date of initial application of ASU 2015-02.

**FAIR VALUE OPTION**

**10.2.20.20.** Reporting enterprises that are required to consolidate a VIE as a result of the initial application of ASU 2015-02 may elect the fair value option under ASC Subtopic 825-10, *Financial Instruments – Overall*, if the reporting enterprise elects the option for all qualifying financial assets and liabilities of that VIE. The FASB’s concern about permitting a fair value election on an instrument-by-instrument basis was that reporting enterprises may use the election to achieve desired accounting results that are inconsistent with the objectives of ASC Topic 825, *Financial Instruments*. However, the fair value election should be made on a VIE-by-VIE basis.

**10.2.20.30.** Along with the other disclosures required within ASC Section 825-10-50, entities electing the fair value option to measure newly consolidated VIEs must disclose all of the following:

- Management’s reasons for electing the fair value option for a particular VIE or group of VIEs.
The reasons for different elections if the fair value option is elected for some VIEs and not others.

Quantitative information by line item in the balance sheet that indicates the related effect on the cumulative-effect adjustment to retained earnings of electing the fair value option for a VIE.

**Question 10.2.20.3: Fair Value Option**

Can an enterprise elect to apply the fair value option in ASC Topic 825 to VIEs that must be consolidated as a result of ASU 2015-02?

**Interpretive Response:** Yes. However, an enterprise that is required to consolidate a VIE as a result of the initial application of ASU 2015-02 may elect the fair value option only if it elects the fair value option for all financial assets and liabilities of the VIE that are eligible for the fair value option under ASC Topic 825. If an enterprise elects the fair value option, it is required to provide the disclosures required by ASC Topic 825, and disclose management’s reasons for electing the fair value option for a particular VIE or group of VIEs and the reasons for not electing the fair value option for other VIEs (if applicable). The enterprise is also required to present information by line item in the statement of financial position that indicates the related effect on the cumulative-effect adjustment to retained earnings of electing the fair value option for a VIE.

**10.2.30. Deconsolidation after Initial Application of ASU 2015-02**

**10.2.30.10.** If a reporting enterprise is required to deconsolidate a VIE as a result of the initial application of ASU 2015-02, the reporting enterprise should initially measure any retained interest in the deconsolidated subsidiary at its carrying amount at the date the requirements of ASU 2015-02 first apply. In this context, carrying amount refers to the amount at which any retained interest would have been carried in the reporting enterprise’s financial statements if the guidance in ASU 2015-02 had been effective when the reporting enterprise became involved with the VIE or no longer met the conditions to be the primary beneficiary.

**10.2.30.20.** Differences between the net amount removed from the balance sheet of the deconsolidating reporting enterprise and the amount of any retained interest in the newly deconsolidated VIE should be recognized as a cumulative-effect adjustment to retained earnings. The amount of any cumulative-effect adjustment related to deconsolidation should be disclosed separately from any cumulative-effect adjustment related to consolidation of VIEs.

**10.2.40. Practicability Exception**

**10.2.40.10.** For various reasons, such as a VIE’s lack of sufficiently detailed accounting records (e.g., consolidation after the initial application of ASU 2015-02) or the use of hindsight with respect to impairment (e.g., deconsolidation after the initial application of ASU 2015-02), it may not be practicable for the reporting
enterprise to determine the carrying amounts upon initial application. In these situations, the reporting enterprise should record the assets, liabilities, and noncontrolling interests of the VIE for a consolidation that occurred after the initial application of ASU 2015-02, or the retained interests, if any, for a deconsolidation that occurred after the initial application of ASU 2015-02, at fair value at the date at which ASU 2015-02 first applies. The only exception is when the VIE’s primary beneficiary has changed between enterprises under common control, in which case the assets, liabilities, and noncontrolling interests would be recorded at carryover basis upon consolidation by the reporting enterprise (i.e., the amounts at which they were carried at by the former primary beneficiary).

Question 10.2.40.1: Determining Whether Carrying Amount Measurement Is Not Practicable upon Consolidation

How should an enterprise determine whether it is not practicable to determine carrying amounts when applying ASC subparagraph 810-10-65-7(b)?

Interpretive Response: In general, the FASB has historically concluded that there were no significant practice issues in applying the transition method in FIN 46(R) (unamended ASC Subtopic 810-10) and FASB Accounting Standards Update No. 2009-17 (ASU 2009-17), Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities (originally issued as FASB Statement No. 167, Amendments to FASB Interpretation No. 46(R) (Statement 167)). Therefore, the Board decided to retain a practicability exception similar to that included in unamended ASC Subtopic 810-10 (i.e., before ASU 2009-17’s revisions) and ASU 2009-17 that permits enterprises for whom it is not practicable to determine the carrying amounts of newly-consolidated VIEs to instead measure the assets, liabilities, and noncontrolling interests of VIEs at fair value at the date ASU 2015-02 first applies. Professional judgment will be required when applying the practicability exception in ASC subparagraph 810-10-65-7(b). However, we understand that the Board intended the alternative transition measurement provisions to be an accommodation rather than a high threshold. We also believe it would be acceptable, but not required, to apply the conditions in ASC paragraph 250-10-45-9 for evaluating whether it is impracticable to determine the carrying amounts of a VIE to be consolidated on initial application of ASU 2015-02.

Question 10.2.40.2: Practicability Exception for Determining Carrying Amounts upon Deconsolidation

How should a reporting enterprise determine whether it is practicable to determine the carrying amounts when deconsolidating a subsidiary upon initial application of ASU 2015-02?

Background: ASU 2009-17 provided a practicability exception that permitted reporting enterprises for whom it was not practicable to determine the carrying amount of newly consolidated VIEs to instead measure the assets, liabilities,
and noncontrolling interest of those VIEs at fair value at the date ASU 2009-17 first applied. ASU 2015-02 extends the practicability exception to retained interests in a newly deconsolidated subsidiary.

**Interpretive Response:** Professional judgment and consideration of the relevant facts and circumstances will be required when applying the practicability exception. There are various reasons why it may not be practicable to determine what the carrying amount of a reporting enterprise’s interest would have been had ASU 2015-02’s provisions always been applicable. For example, if the reporting enterprise accounts for its retained interest under the equity method upon deconsolidation, there are differences between the equity method of accounting versus consolidation that it may be impracticable for the reporting enterprise to identify (e.g., with respect to loss recognition). Although the practicability exception is an accommodation, it is not an option. Reporting enterprises will need to make a good faith effort to determine carrying amounts of retained interests in subsidiaries that are deconsolidated upon initial application of ASU 2015-02. However, we do not believe the FASB intended to require reporting enterprises to undertake exhaustive efforts to determine the carrying amounts of retained interests in those former subsidiaries.

**Question 10.2.40.3: Entity-By-Entity Application of the Practicability Exception for Measurement**

Can a reporting enterprise apply the practicability exception for the measurement of assets, liabilities, and noncontrolling interests as described in ASC subparagraph 810-10-65-7(b)(2) and for the measurement of any retained interest as described in ASC subparagraph 810-10-65-7(e)(2) on an entity-by-entity basis?

**Interpretive Response:** Yes, reporting enterprises may apply this practicability exception on an entity-by-entity basis. To illustrate this concept, assume that Parent is a reporting enterprise with a calendar year-end that is required to deconsolidate two VIEs (Entity 1 and Entity 2) upon its initial application of ASU 2015-02 on January 1, 2016. Parent became involved with both VIEs when they were formed, which occurred on January 1, 2013 and March 31, 2014, respectively. While Parent has access to the information necessary to determine the retained interest in Entity 1, it lacks sufficient information for Entity 2 and will apply the practicability exception. In this situation, Parent will measure the retained interest as of January 1, 2013 for Entity 1 and then roll forward this balance to January 1, 2016 (date of Parent’s initial application of ASU 2015-02) using the equity method of accounting. However, because Parent is applying the practicability exception for Entity 2, it is required to measure its retained interest at fair value as of the date of initial application (i.e., January 1, 2016). Additionally, Parent should record any differences between the net amounts removed from the balance sheet and the amounts of
its retained interests in the VIEs as a cumulative-effect adjustment to retained earnings as of January 1, 2016.

**Question 10.2.40.4: Consideration of When It Is Not Practicable to Apply ASU 2015-02’s Initial Measurement and Recognition Provisions**

What are some factors that a reporting enterprise should consider when evaluating whether it is not practicable to apply the initial measurement and recognition provisions of ASU 2015-02?

**Interpretive Response:** While ASU 2015-02 provides no definition for, or guidance surrounding, the meaning of *not practicable*, we believe that the following list provides examples of factors that reporting enterprises should consider when making this determination:

- **Granularity of the VIE’s books and records.** For example, evaluate whether the books and records of the VIE are sufficiently detailed that would allow for retrospective application of ASU 2015-02’s guidance. Where the data collected in and of itself would be insufficient to retrospectively apply ASU 2015-02, assess whether it would be impracticable to aggregate the data necessary for retrospective application.

- **Cost and burden.** Consider whether the costs necessary for the reporting enterprise to apply the initial measurement and recognition provisions of ASU 2015-02 would be prohibitive and how laborious and time consuming the process would be.

- **Need to revisit assumptions.** It may be more impracticable for reporting enterprises to apply ASU 2015-02’s initial measurement and recognition provisions when assumptions needed to determine the carrying amounts require the use of hindsight, or where management would need to make assumptions about the reporting enterprise’s prior intentions.

Additionally, reporting enterprises that use any of the practicability exceptions provided by ASU 2015-02 should clearly document their rationale for doing so.

**10.2.50. Method of Transition**

**10.2.50.10.** The requirements of ASU 2015-02 may be adopted either by (a) recording a cumulative-effect adjustment as of the date of initial application or (b) applying the guidance retrospectively in previously issued financial statements for one or more full fiscal years with a cumulative-effect adjustment to retained earnings as of the beginning of the first year restated. A reporting enterprise is required to describe the transition method(s) applied and to disclose the amount and classification in its statement of financial position of the consolidated assets or liabilities by the transition method(s) applied. A reporting enterprise is also
required to disclose the amount of any cumulative-effect adjustment related to deconsolidation separately from any cumulative-effect adjustment related to consolidation of entities. Additionally, the reporting enterprise cannot elect its method of initial application on an entity-by-entity basis. That is, it cannot elect to retrospectively adopt ASU 2015-02 for one group of VIEs while recording a cumulative-effect adjustment for another group of VIEs.

10.2.50.20. Ideally, there should be no difference in the balance sheet of the reporting enterprise at the date of initial application under either alternative because the measurement methodology under the cumulative-effect alternative is to determine the U.S. GAAP carrying value of the VIE’s assets, liabilities, and noncontrolling interests (for consolidation) or any retained interest (for deconsolidation) on the date of initial application as if the provisions of ASU 2015-02 always were in effect. If that is not practicable, ASU 2015-02 permits assets, liabilities, and noncontrolling interests of (for consolidation), or any retained interest in (for deconsolidation), the VIE to be measured at fair value on the date of initial application. Note that when an enterprise obtains the information necessary to apply the provisions of ASU 2015-02 to an entity for which the information out scope exception previously was applied, only the cumulative-effect adjustment transition methodology may be applied.

10.2.50.30. A comparison of the two methods of initial application is provided in Example 10.2.50.1.

Example 10.2.50.1: Cumulative-Effect and Retrospective Application Adjustments

Description of the Arrangement

A reporting enterprise, Company X, will adopt ASU 2015-02 on January 1, 2016 (Company X is a calendar year-end public business entity). Company X has been involved with two VIEs, an investment fund and a limited partnership. Company X did not consolidate the investment fund structure but consolidated the limited partnership under existing U.S. GAAP.

Details of Company X’s involvement with the two VIEs are as follows:

VIE 1

Investment Fund is a VIE that was created on January 1, 2014 to acquire a portfolio of debt securities with similar terms and maturities. Investment Fund was financed with equity from two investors: Manager Y (5%) and Company X (95%). Company X owns 25% of Manager Y’s equity. Manager Y is the asset manager of the VIE and for its services receives fees that are commensurate with the services provided and only include customary terms and conditions. Manager Y has the power to direct the activities that most significantly impact Investment Fund’s economic performance. Company X does not have the right to remove Manager Y as the asset manager without cause and lacks any other rights to participate in the decisions about Investment Fund’s activities.
Historical data:

Debt securities cost: $5,000,000

Acquired: January 1, 2014

Annual credit losses: None for the first two years

Debt securities amortized cost amounts:

<table>
<thead>
<tr>
<th>Date</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/2014</td>
<td>$4,657,208</td>
</tr>
<tr>
<td>12/31/2015</td>
<td>$4,286,499</td>
</tr>
</tbody>
</table>

Interest income recognized:

<table>
<thead>
<tr>
<th>Date</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/2014</td>
<td>$407,208</td>
</tr>
<tr>
<td>12/31/2015</td>
<td>$379,291</td>
</tr>
</tbody>
</table>

Management fees: $37,500 per year

Distributions: None for the first two years

Evaluation

Company X concluded that it would be the primary beneficiary of Investment Fund at the inception of the entity under the requirements of ASU 2015-02 because:

Investment Fund has a single decision maker (Manager Y),
Manager Y is part of a group of related parties with Company X that are not under common control and that collectively meets the criteria to be considered the VIE’s primary beneficiary, and
Substantially all of the VIE’s activities are conducted on behalf of Company X.

Cumulative-Effect Adjustment

ASC subparagraph 810-10-65-7(b)(1) requires Company X, when determining the cumulative-effect adjustment, to measure the assets and liabilities consolidated on initial application of ASU 2015-02 at their carrying amounts when it is practicable to do so. Carrying amounts refers to the amounts at which the assets, liabilities, and noncontrolling interests would have been measured had ASU 2015-02 been applied when Company X first became involved with the VIE (i.e., January 1, 2014).
Cumulative-Effect Adjustment Analysis

Balance sheet caption of Company X at December 31, 2015 as it relates to its investment in Investment Fund before initial application of ASU 2015-02:

Assets
- Investment in Investment Fund $5,435,424

Financial statements of Investment Fund:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$ 712,500</td>
<td>$1,425,000</td>
</tr>
<tr>
<td>Debt securities</td>
<td>4,677,208</td>
<td>4,296,499</td>
</tr>
<tr>
<td>Total assets</td>
<td>$5,389,708</td>
<td>$5,721,499</td>
</tr>
<tr>
<td>Net assets</td>
<td>$5,389,708</td>
<td>$5,721,499</td>
</tr>
</tbody>
</table>

Income Statement

<table>
<thead>
<tr>
<th>12 Months</th>
<th>2014</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest on debt securities</td>
<td>$407,208</td>
<td>$379,291</td>
</tr>
<tr>
<td>Operating expense</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Management fees</td>
<td>37,500</td>
<td>37,500</td>
</tr>
<tr>
<td>Net investment income</td>
<td>369,708</td>
<td>341,791</td>
</tr>
<tr>
<td>Net increase (decrease) in unrealized appreciation on debt securities</td>
<td>20,000</td>
<td>(10,000)</td>
</tr>
</tbody>
</table>

Net income\(^1\) $389,708 $331,791

Cumulative-effect adjustment:
- Dr. Cash $1,425,000
- Dr. Debt securities 4,296,499
- Cr. Investment in Investment Fund $5,435,424
- Cr. Noncontrolling interest 286,075

\(^1\) Income taxes have been excluded from the example for ease of illustration.

Retrospective Application

If retrospective application was elected, the above analysis would be the same except that there would be no cumulative-effect adjustment because Investment Fund was created at the beginning of the earliest period presented.

The restated equity position at January 1, 2016 under the retrospective application approach would be the same as the equity position under the cumulative-effect transition approach.
Limited Partnership is an entity that Company X established January 1, 2014 to acquire a stabilized, leased (triple net) commercial real estate property. Company X is the general partner and made an initial equity contribution of $40,000, which did not qualify to be considered at risk. Limited Partnership has no other characteristics of a VIE. Three limited partners unrelated to Company X contributed the remaining initial partnership equity in the amount of $1,960,000. Each limited partner holds a third of the LP interests. For its services as the general partner of Limited Partnership Company X earns base, fixed senior and subordinated fees, and a performance-based fee in which it receives a portion of Limited Partnership's profits above a targeted return. The fees are considered commensurate with the services provided and only include customary terms and conditions. The limited partners have no kick-out, liquidation, or participating rights. Therefore, Company X consolidated Limited Partnership from its inception. Limited Partnership has senior debt financing totaling $3,000,000 that is nonrecourse to the partners or other assets of the partnership.

On July 1, 2015, the only tenant of the commercial real estate property defaulted on its lease. Consequently, Limited Partnership concluded that the property was impaired and recognized an impairment expense of $2,000,000.

Historical data:

- Property cost: $5,000,000
- Depreciation: $250,000 per year before impairment; $148,649 per year after impairment
- Lease payments: $420,000 per year
- Tenant default: July 1, 2015
- Property impairment: $2,000,000 on July 1, 2015
- Debt: $3,000,000 @ 5% fixed, interest only for 10 years
- Distributions: 90% of net cash from operations in first 5 years.

**Evaluation**

Company X concluded that it would not consolidate Limited Partnership at the inception of the entity under the requirements of ASU 2015-02 because its fees do not represent a variable interest in Limited Partnership.
**Cumulative-Effect Adjustment**

ASC subparagraph 810-10-65-7(e) requires Company X, when determining the cumulative-effect adjustment, to measure any retained interest in the deconsolidated former subsidiary at its carrying amount, which refers to the amount at which any retained interest would have been measured had ASU 2015-02 been applied when Company X first became involved with the entity.

**Cumulative-Effect Adjustment Analysis**

Financial statements of Limited Partnership at December 31, 2014 and 2015:

<table>
<thead>
<tr>
<th></th>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$24,000</td>
<td>$27,000</td>
</tr>
<tr>
<td>Office building</td>
<td>5,000,000</td>
<td>2,750,000</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>(250,000)</td>
<td>(74,324)</td>
</tr>
<tr>
<td>Total assets</td>
<td>$4,774,000</td>
<td>$2,702,676</td>
</tr>
</tbody>
</table>

| Liabilities and Equity |               |               |
| Note payable          | $3,000,000    | $3,000,000    |
| GP interest           | 39,800        | (1,086)       |
| LP interests          | 1,734,200     | (296,238)     |
| Total liabilities and equity | $4,774,000 | $2,702,676 |

12 Months 2014 12 Months 2015

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
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<tbody>
<tr>
<td>Revenue</td>
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<td></td>
</tr>
<tr>
<td>Rental income</td>
<td>$420,000</td>
<td>$210,000</td>
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</table>

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation</td>
<td>250,000</td>
<td>74,324</td>
</tr>
<tr>
<td>Impairment</td>
<td>-</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Interest expense</td>
<td>150,000</td>
<td>150,000</td>
</tr>
<tr>
<td>Management fees</td>
<td>30,000</td>
<td>30,000</td>
</tr>
<tr>
<td><strong>Net loss</strong></td>
<td><strong>$10,000</strong></td>
<td><strong>$2,044,324</strong></td>
</tr>
</tbody>
</table>

Company X is not obligated to fund operating losses of Limited Partnership and, therefore, would recognize an investment balance of $0 at December 31, 2015 after initial application of ASU 2015-02.
Cumulative-effect adjustment:

- Dr. Note payable $3,000,000
- Dr. Accumulated depreciation 74,324
  - Cr. Noncontrolling interest $ 296,238
  - Cr. Cash 27,000
  - Cr. Office building 2,750,000
  - Cr. Cumulative-effect adjustment 1,086

Retrospective Application

If Company X elected to retrospectively apply ASU 2015-02, the above analysis would be the same, except that the cumulative-effect adjustment would be recorded through opening retained earnings of the earliest period presented with remaining adjustments reflected in the relevant income statement captions in the appropriate period.

The retained interest and restated equity positions at January 1, 2016 under the retrospective application approach would be the same as they would be under the cumulative-effect transition approach.

Question 10.2.50.1: Periods Presented When the Provisions of ASU 2015-02 Are Retrospectively Applied

If a company elects to retrospectively apply the provisions of ASU 2015-02, should the restatement be determined as though ASU 2015-02 was in effect for all periods presented, or based only on the variable interest entities for which the reporting enterprise is the primary beneficiary as of the effective date?

Interpretive Response: The restatement should be determined as though ASU 2015-02 was in effect for all periods restated, and the periods restated must be full fiscal years. The restatement should not be determined based on only the variable interest entities for which the reporting enterprise is the primary beneficiary as of the date of initial application. ASC subparagraph 810-10-65-7(j) states that for transition by restatement, a cumulative-effect adjustment should be determined as of the beginning of the first year restated. We believe a restatement that is based only on the variable interest entities for which the reporting enterprise is the primary beneficiary as of the date of initial application (e.g., January 1, 2016 for calendar year-end public business entities) is inconsistent with the transition guidance in ASU 2015-02 and with
the underlying objective of restating financial statements, which is to provide comparable information for all periods presented.

ASC subparagraph 810-10-65-7(j) does not require restatement for all periods presented, but does require restatement for one or more years if the restatement alternative is elected. For example, our understanding of an acceptable restatement transition presentation for a calendar-year public business entity includes restatement of the period from January 1, 2016 to June 30, 2016 and the fiscal year ended December 31, 2015. Conversely, we understand that the FASB did not intend restatement of only the period from January 1, 2016 to June 30, 2016 to be considered an acceptable restatement transition presentation. Preparers and auditors should consider applicable guidance about reports on audited financial statements presented with prior-period financial statements audited by a predecessor auditor who has ceased operations in evaluating whether an entity that elects to adopt the provisions by restatement requires a re-audit.

Question 10.2.50.2: Inclusion of Consolidated VIEs in Managements’ Reports on Internal Control Over Financial Reporting

Are VIEs that are required to be consolidated on the effective date of ASU 2015-02 required to be included in managements’ reports on internal control over financial reporting (ICFR)?

Interpretive Response: Yes, with one exception. In a speech at the 2009 AICPA National Conference on Current SEC and PCAOB Developments, a member of the SEC staff indicated that registrants would be expected to include VIEs consolidated on the effective date of ASU 2009-17 in managements’ reports on ICFR. An excerpt from the speech follows. Although the speech related to the initial adoption of ASU 2009-17, we believe it is still relevant when initially applying ASU 2015-02.

Excerpt from Speech by Doug Besch

Registrants that consolidate VIEs upon adoption of [ASU 2009-17] will do so because they control these entities, and therefore, registrants will be expected to include those entities in managements’ reports on ICFR. Further, the consolidation of VIEs under the transition provisions in [ASU 2009-17] does not constitute a business combination transaction for the purpose of determining whether the newly consolidated entity may be excluded from managements’ reports on ICFR. The guidance contained in questions one and three of the September 2007 SEC staff frequently asked questions describe situations where the staff would not object to registrants excluding certain VIEs and material business combinations from their reports on ICFR. However, with one exception, registrants will not be able to justify excluding VIEs consolidated upon adoption of [ASU 2009-17] from their reports on ICFR using this guidance. This is because the staff believes registrants that
consolidate VIEs under [ASU 2009-17] will likely have the right or authority to assess the internal controls of the consolidated entity, and since the consolidation will occur as of the first day of the fiscal year, registrants will have sufficient time to perform that assessment. The one exception, which the staff expects to rarely occur, relates to registrants consolidating VIEs that were in existence prior to December 15, 2003 for which the registrant, despite having control, does not possess the right or authority to assess the consolidated entity’s internal controls and also lacks the ability, in practice, to make that assessment.


10.3. ASU 2016-17, INTERESTS HELD THROUGH RELATED PARTIES THAT ARE UNDER COMMON CONTROL

10.3.10.10. In October 2016, the FASB changed the guidance about how a single decision maker should consider indirect interests held by related parties that are under common control. Currently, ASC paragraph 810-10-25-42 requires the single decision maker to consider interests held by related parties that are under common control in their entirety when evaluating whether it has a potentially significant variable interest. ASU 2016-17 requires the single decision maker to consider indirect interests held through related parties that are under common control on a proportionate basis. This change will result in the single decision maker considering all indirect interests held through related parties on a proportionate basis regardless of whether it is under common control with the related party.

10.3.10.20. The ASU is effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2016. For all other entities, it is effective for annual periods in fiscal years beginning after December 15, 2016, and interim periods in fiscal years beginning after December 15, 2017. Entities that have not adopted ASU 2015-02 should adopt ASU 2016-17 at the same time and apply the same transition method for both standards. Entities that already adopted ASU 2015-02 should apply ASU 2016-17 retrospectively to all periods beginning with the earliest annual period in which they adopted ASU 2015-02. Entities can adopt ASU 2016-17 immediately, including in an interim period. However, if an entity adopts the ASU in an interim period other than the first interim period of its fiscal year, it should compute and reflect the cumulative effect of the accounting change as of the beginning of the fiscal year that includes that interim period.
10.4. ASU 2017-02, CLARIFYING WHEN A NOT-FOR-PROFIT ENTITY THAT IS A GENERAL PARTNER OR A LIMITED PARTNER SHOULD CONSOLIDATE A FOR-PROFIT LIMITED PARTNERSHIP OR SIMILAR ENTITY

10.4.10.10. In January 2017, the FASB issued Accounting Standards Update No. 2017-02. ASU 2017-02 clarifies how not-for-profit entities (NFPs) should evaluate partnership investments for consolidation after the adoption of ASU 2015-02.

10.4.10.20. Under ASU 2015-02, investors in limited partnerships must first evaluate whether those partnerships are variable interest entities. If so, the variable interest entity consolidation guidance applies. If not, the voting interest entity consolidation guidance applies. ASU 2015-02 also changed how investors in partnerships that are voting interest entities evaluate those partnerships for consolidation. It eliminated the presumption that the general partner controls a limited partnership. Instead, it requires investors to evaluate partnerships that are voting interest entities in generally the same manner as corporations that are voting interest entities (i.e., based on whether the investor has a majority of the voting rights). Because ASU 2015-02 first requires investors to evaluate whether the partnership is a VIE and NFPs generally do not apply the VIE guidance (as discussed above), it was unclear how NFPs should evaluate whether to consolidate for-profit limited partnerships.

10.4.10.30. ASU 2017-02 restores for NFPs the pre-ASU 2015-02 consolidation guidance related to partnerships and similar entities that are not variable interest entities. NFPs that are general partners are, once again, presumed to control a limited partnership, regardless of the extent of their ownership interest, unless the limited partners have substantive participating or kick-out rights. The ASU also states that the FASB did not intend to change the fair value elections currently available to NFPs. It clarifies that the consolidation guidance does not apply to an NFP that invests in a for-profit limited partnership or similar legal entity if the partnership interest is reported at fair value under U.S. GAAP.

10.4.10.40. ASU 2017-02 is effective for annual periods in fiscal years beginning after December 15, 2016, and for interim periods in fiscal years beginning after December 15, 2017, with early adoption permitted. NFPs will apply the ASU using the same transition method elected for ASU 2015-02. NFPs that have already adopted ASU 2015-02 will apply ASU 2017-02 retrospectively to all relevant prior periods beginning with the fiscal year in which ASU 2015-02 initially was adopted.
Appendix A – Expected Losses and Expected Residual Returns

ENTITY-LEVEL EXPECTED LOSSES AND EXPECTED RESIDUAL RETURNS

Concepts Statement 7

Example A.1: Expected Cash Flows from Aircraft Operations
Example A.2: Expected Variability in Cash Flows from Aircraft Operations
Example A.3: Expected Losses and Expected Residual Returns from a Business Jet

Interests in Specified Assets of a Variable Interest Entity

Example A.4: Expected Losses and Expected Residual Returns in Specified Assets

Based on the calculations summarized in Table 11, the level of equity required by the entity to demonstrate that its equity is sufficient to finance its own operations is any amount greater than $4.834 million. Although the 10% presumption in ASC paragraph 810-10-25-45 would indicate that the entity needs equity of at least $8.5 million (based on assets of $85 million), that presumption is overcome because the entity’s expected losses are less than 10% of its assets. In addition, even though the entity has equity at risk with a fair value of $17 million, it is a VIE because the members lack the power, through voting rights or similar rights, to direct the activities that most significantly impact the LLC’s economic performance, based on the application of ASC subparagraph 810-10-15-14(b)(1)(ii) for limited partnerships and similar entities. We believe that for many entities similar to limited partnerships, the provisions of ASC subparagraph 810-10-15-14(b)(1)(ii) are more likely to cause the entity to be a VIE than are the provisions of ASC subparagraph 810-10-15-14(a).

Question A.1: Consideration of an Entity’s Design in Calculating Expected Losses and Expected Residual Returns
Question A.2: Consideration of Interest Rate Risk in By Design Analysis of Variability
Question A.3: Effect of Guidance in ASC Topic 820 on Calculations of Expected Losses and Expected Residual Returns
Question A.4: Calculating Expected Losses and Expected Residual Returns When an Entity Has an Indefinite Life
Question A.5: Number of Possible Cash Flow Scenarios in Calculating Expected Losses and Expected Residual Returns
Question A.6: Methods of Measuring Expected Losses and Expected Residual Returns
Question A.7: Expected Losses for Profitable Entities
Question A.8: Consideration of Tax Benefits Received by Variable Interest Holders in Determining an Entity’s Expected Losses and Expected Residual Returns

ALLOCATING EXPECTED LOSSES AND EXPECTED RESIDUAL RETURNS TO VARIABLE INTERESTS

Example A.5: Proportionate Variability Approach to Allocating Variability
Question A.9: Consideration of Variable Interest Holders’ Credit Risk in Allocating an Entity’s Expected Losses
The concepts of expected losses and expected residual returns, which are used as the measure of an entity’s economic risks and rewards, are two of the key concepts in applying the VIE consolidation guidance in ASC Subtopic 810-10, *Consolidation - Overall*. Expected losses and expected residual returns are collectively referred to as expected variability. Expected losses are an integral aspect of the VIE consolidation model because they are one of the considerations used to identify whether an entity is a VIE. Expected variability is relevant in determining an entity’s variable interest holders, which affects the identification of the primary beneficiary, if any. These concepts are some of the most difficult to understand and apply in ASC Subtopic 810-10. Unfortunately, the concepts of expected losses and expected residual returns are not intuitive, in part, because the labels given to them do not convey the fundamental underlying concepts. In particular, expected losses do not represent the U.S. GAAP losses that investors expect the entity to incur and expected residual returns do not represent U.S. GAAP earnings that investors expect the entity to produce.

Expected losses, expected residual returns, and expected variability are defined in ASC Section 810-10-20, as follows:

<table>
<thead>
<tr>
<th>Excerpts from ASC Section 810-10-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Expected Losses</strong></td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td><strong>Expected Losses and Expected Residual Returns</strong></td>
</tr>
<tr>
<td>Expected losses and expected residual returns refer to amounts derived from expected cash flows as described in FASB Concepts Statement No. 7, <em>Using Cash Flow Information and Present Value in Accounting Measurements</em>. However, expected losses and expected residual returns refer to amounts discounted and otherwise adjusted for market factors and assumptions rather than to undiscounted cash flow estimates. The definitions of <strong>expected losses</strong> and <strong>expected residual returns</strong> specify which amounts are to be considered in determining expected losses and expected residual returns of a variable interest entity (VIE).</td>
</tr>
<tr>
<td><strong>Expected Residual Returns</strong></td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td><strong>Expected Variability</strong></td>
</tr>
<tr>
<td>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.</td>
</tr>
</tbody>
</table>
ENTITY-LEVEL EXPECTED LOSSES AND EXPECTED RESIDUAL RETURNS

A.002 ASC Subtopic 810-10 requires expected losses and expected residual returns to be derived from a discounted present value cash flow calculation using the expected cash flow methodology described in FASB Concepts Statement No. 7, Using Cash Flow Information and Present Value in Accounting Measurements. As noted in the definitions of expected losses and expected residual returns, the expected cash flows used to derive an entity’s expected losses and expected residual returns exclude variable interests – items that absorb the entity’s variability – including, but not limited to, fees paid to certain service providers, certain derivative contracts, and investments in equity or debt of the entity. Variable interests are discussed in greater detail in Section 3, Variable Interests. The variability in the fair value of net assets includes variability in the entity’s net operating results. The variability in the fair value of the net assets does not include the effects of the variable interest itself. (Note that variability in the entity’s net operating results also implicitly is determined exclusive of variable interests.) ASC paragraphs 810-10-25-55 through 25-57 provide additional guidance about variability to be included in calculating expected losses and expected residual returns (see Section 3 and Section 5, Silos).

Concepts Statement 7

A.003 Concepts Statement 7 provides general principles to be applied in performing present value cash flow measurements, particularly where the amount of future cash flows, their timing, or both, are uncertain.

A.004 Concepts Statement 7 acknowledges that accounting present value applications typically have been performed using a single set of estimated cash flows and a single interest rate. In this traditional or best estimate approach, uncertainties about matters such as the timing or amount of future cash flows are addressed through the selection of a discount rate that reflects the risks inherent in the single estimate of cash flows. Concepts Statement 7 indicates that the traditional or best estimate approach is appropriate when performing present value calculations with respect to items with contractual cash flows or for which comparable assets and liabilities can be observed in the marketplace. In Concepts Statement 7, the FASB introduced the expected cash flow approach, which differs from the traditional or best estimate approach by identifying the range of estimated cash flows and the respective probabilities associated with each of the individual cash flow estimates. That approach, in the FASB’s view, theoretically makes possible more precise present value cash flow estimates when the timing or amount of cash flows is uncertain by incorporating a range of possible outcomes.

A.005 Under the expected cash flow approach, a range of estimated cash flows is identified, each with an estimated probability of occurrence. (Probabilities must total 100% for a specific expected cash flow estimate.) Each estimated cash flow is discounted to present value using a risk-free interest rate (representing only
the time value of money) and is multiplied by the applicable probability to compute the overall expected cash flow. Because the uncertainties associated with the present value estimate have been reflected in the distribution of estimated cash flows (i.e., different estimated amounts and timing), Concepts Statement 7 indicates that it is inappropriate for the discount rate to represent anything other than the time value of money. Factors such as (a) expectations about possible variations in the amount or timing of cash flows, (b) the price for bearing the uncertainty inherent in the asset or liability, and (c) other, sometimes unidentifiable, factors including illiquidity and market imperfections, which affect the discount rate in a traditional present value estimate, should not be included in the discount rate used for purposes of the expected cash flow approach because those factors are reflected in the expected cash flows.

A.006 To illustrate the difference between the expected cash flow methodology and the traditional approach, Concepts Statement 7 uses a simple example in which $1,000 may be received in one year, two years, or three years with probabilities of 10%, 60%, and 30%, respectively. The example illustrates that, rather than calculating a present value of $903 under the traditional approach based on the most likely scenario in which the $1,000 will be received in two years (and discounted at an interest rate of 5.25%), the expected cash flow approach yields a present value calculation of $892 based on the weighted average of each of the individual cash flows multiplied by their respective probabilities of occurrence (and discounted at interest rates of 5%, 5.25%, and 5.5%, respectively).

A.007 Even though the FASB example in Concepts Statement 7 incorrectly did not include a risk adjustment to the discount rate used in the traditional approach (which would have reduced the present value estimate under that approach), the example nonetheless illustrates the difficulty inherent in making all necessary adjustments for variances in both timing and amount of cash flows in the selection of an appropriate discount rate. The FASB has indicated that in performing present value calculations the expected cash flow approach is preferable when the timing or amount of cash flows is uncertain or when comparable assets and liabilities cannot be observed in the marketplace. The FASB illustrated the calculation of expected cash flows in ASC Subtopic 810-10. In the illustration, which follows, the amounts in the fair value column represent the present value of the amounts in the expected cash flows column discounted at the risk-free rate.

Excerpt from ASC Subtopic 810-10

Example 1: Expected Losses, Expected Residual Returns, and Expected Variability

55-42 This Example illustrates a computation of expected losses, expected residual returns, and expected variability and is intended to explain the meaning of those terms. Entities will not necessarily be able to estimate probabilities to use a precise computation of the type illustrated, but they
should use their best efforts to achieve the objective described. This Example is based on a hypothetical pool of financial assets with total contractual cash flows of $1 billion and has the following assumptions:

(a) A single party holds all of the beneficial interests in the VIE, and the VIE has no liabilities.

(b) There is no decision maker because the VIE’s activities are completely predetermined.

(c) All cash flows are expected to occur in one year or not to occur at all.

(d) The appropriate discount rate (the interest rate on risk-free investments) is 5 percent.

(e) No other factors affect the fair value of the assets. Thus, the present value of the expected cash flows from the pool of financial assets is assumed to be equal to the fair value of the assets.

55-43 This Example uses a simple situation intended to illustrate the concepts of expected losses, expected residual returns, and expected variability. Since it is assumed that there is only one party involved, the identity of the primary beneficiary is obvious.

55-44 The following table shows the computation of expected cash flows using the cash flow possibilities that the variable interest holder has identified. The items to be included in expected cash flows of a VIE are described in the definition of the terms expected losses, expected residual returns, and expected variability.

<table>
<thead>
<tr>
<th>Estimated Cash Flows</th>
<th>Probability</th>
<th>Expected Cash Flows</th>
<th>Fair Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 650,000</td>
<td>5.0%</td>
<td>$ 32,500</td>
<td>$ 30,952</td>
</tr>
<tr>
<td>700,000</td>
<td>10.0%</td>
<td>70,000</td>
<td>66,667</td>
</tr>
<tr>
<td>750,000</td>
<td>25.0%</td>
<td>187,500</td>
<td>178,571</td>
</tr>
<tr>
<td>800,000</td>
<td>25.0%</td>
<td>200,000</td>
<td>190,477</td>
</tr>
<tr>
<td>850,000</td>
<td>20.0%</td>
<td>170,000</td>
<td>161,905</td>
</tr>
<tr>
<td>900,000</td>
<td>15.0%</td>
<td>135,000</td>
<td>128,571</td>
</tr>
</tbody>
</table>

100.0% $ 795,000 $ 757,143

55-45 The expected cash flows are $795,000, and the fair value of the pool of assets is $757,143.
Example A.1: Expected Cash Flows from Aircraft Operations

Following is an illustration of the expected cash flow approach involving the operations of an aircraft over a five-year period. In this example the timing of the cash flows is assumed to be certain but the amount of cash flows could vary.

Table 1
Cash Flows From Aircraft Operations\(^1\)
(Dollars in Thousands)

<table>
<thead>
<tr>
<th>A</th>
<th>B(^2)</th>
<th>C</th>
<th>D = B × C</th>
</tr>
</thead>
<tbody>
<tr>
<td>$6,247</td>
<td>$27,812</td>
<td>15%</td>
<td>$4,172</td>
</tr>
<tr>
<td>6,909</td>
<td>30,759</td>
<td>20%</td>
<td>6,152</td>
</tr>
<tr>
<td>7,409</td>
<td>32,985</td>
<td>30%</td>
<td>9,895</td>
</tr>
<tr>
<td>7,809</td>
<td>34,765</td>
<td>25%</td>
<td>8,691</td>
</tr>
<tr>
<td>8,587</td>
<td>38,228</td>
<td>10%</td>
<td>3,823</td>
</tr>
<tr>
<td>100%</td>
<td>$32,733</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

\(^1\) This example of an expected cash flow analysis is not meant to conform to the definition of expected variability in ASC Section 810-10-20. To conform to that definition, this analysis would need to include variability in cash flows from the potential fair value of the aircraft at the end of the five-year period.

\(^2\) Present value is determined based on a five-year annuity of the amount in column A discounted at a risk-free rate of 4%.

A.008 Like the other FASB Concepts Statements, Concepts Statement 7 is not a part of authoritative generally accepted accounting principles unless other guidance in the FASB Codification specifically makes it so. However, that is precisely what the FASB did with respect to applying the expected cash flow methodology in calculating an entity’s expected losses. Therefore, even if the assets or liabilities of an entity otherwise justify the use of the traditional approach (based on the considerations prescribed in Concepts Statement 7), or other approaches such as those described in ASC Topic 820, *Fair Value Measurement*, ASC Subtopic 810-10 requires present value estimates to be performed using the expected cash flow methodology.

A.009 The reason that ASC Subtopic 810-10 requires the expected cash flow methodology to be used to derive expected losses and expected residual returns is because an expected cash flow distribution gives rise to mathematical
variability around the overall arithmetic mean. ASC Subtopic 810-10 uses that variability as the measure of an entity’s economic risks and rewards. Without the use of an expected cash flow approach, the variability associated with a given asset or liability would appear to be zero (because of the use of a single best estimate of possible cash flows). In addition, higher discount rates also reduce the amount of variability in an expected cash flow calculation. The requirement to use the risk-free discount rate (rather than a risk-adjusted rate) and to reflect risks associated with the uncertainty of the expected cash flows in their probability assignments was intended to maximize the quantification of an entity’s economic risks and rewards.

A.010 In ASC Subtopic 810-10, each estimated cash flow in an expected cash flow estimate, when compared with overall expected cash flows (i.e., the weighted average), results in a positive or negative difference. These positive and negative differences, when multiplied by the probabilities associated with the individual estimated cash flows, represent the potential for variability in cash flows from the expected (or weighted average) cash flows. Expected losses comprise the negative amounts (negative variability) and expected residual returns comprise the positive amounts (positive variability). It is a mathematical certainty in this approach that negative variability and positive variability will always offset each other (i.e., they are equal and opposite) as illustrated in the continuation of the FASB’s calculation of expected cash flows in ASC Subtopic 810-10, which follows:

Excerpt from ASC Subtopic 810-10

Example 1: Expected Losses, Expected Residual Returns, and Expected Variability

55-46 The following table shows how expected losses are computed once the expected cash flows are determined. Estimated cash flows (possible outcomes) are compared with the computed expected cash flows (probability-weighted outcomes). Estimated cash flows that are less than the expected cash flows contribute to expected losses, and cash flow possibilities that exceed the expected cash flows contribute to expected residual returns.

<table>
<thead>
<tr>
<th>Estimated Cash Flows (a)</th>
<th>Expected Cash Flows</th>
<th>Difference Estimated (Losses)</th>
<th>Probability</th>
<th>Expected Losses Based on Expected Cash Flows</th>
<th>Expected Losses Based on Fair Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>$650,000</td>
<td>$795,000</td>
<td>$(145,000)</td>
<td>5.0%</td>
<td>$(7,250)</td>
<td>$(6,905)</td>
</tr>
<tr>
<td>700,000</td>
<td>795,000</td>
<td>(95,000)</td>
<td>10.0</td>
<td>(9,500)</td>
<td>(9,048)</td>
</tr>
<tr>
<td>750,000</td>
<td>795,000</td>
<td>(45,000)</td>
<td>25.0</td>
<td>(11,250)</td>
<td>(10,714)</td>
</tr>
<tr>
<td>800,000</td>
<td>795,000</td>
<td>5,000</td>
<td>25.0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>850,000</td>
<td>795,000</td>
<td>55,000</td>
<td>20.0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>900,000</td>
<td>795,000</td>
<td>105,000</td>
<td>15.0</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td>100.0%</td>
<td>$28,000</td>
<td>$26,567</td>
</tr>
</tbody>
</table>

(a) The computation in this Example uses the probability times the difference between the estimated cash flows and expected cash flows and then discounts the result to arrive at fair value. The same result can be achieved by using the probability times the difference between the present value of the estimated cash flows and the fair value. In situations in which the timing of the cash flows varies, that alternate form may be easier to use.
The term expected losses refers to the expected losses based on fair value (using fair value as the benchmark), which in this Example is $26.667 million.

The following table shows how expected residual returns are computed for the same pool of assets.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 650,000</td>
<td>$ 795,000</td>
<td>$(145,000)</td>
<td>5.0%</td>
<td>$ 1,250</td>
<td>$ 1,191</td>
</tr>
<tr>
<td>700,000</td>
<td>795,000</td>
<td>(95,000)</td>
<td>10.0</td>
<td>11,000</td>
<td>10,476</td>
</tr>
<tr>
<td>750,000</td>
<td>795,000</td>
<td>(45,000)</td>
<td>25.0</td>
<td>15,750</td>
<td>15,000</td>
</tr>
<tr>
<td>600,000</td>
<td>795,000</td>
<td>5,000</td>
<td>$</td>
<td>20,000</td>
<td>20,000</td>
</tr>
<tr>
<td>650,000</td>
<td>795,000</td>
<td>55,000</td>
<td>23.0</td>
<td>11,000</td>
<td>10,476</td>
</tr>
<tr>
<td>900,000</td>
<td>795,000</td>
<td>165,000</td>
<td>15.0</td>
<td>15,750</td>
<td>15,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td><strong>100.0%</strong></td>
<td><strong>20,000</strong></td>
<td><strong>20,000</strong></td>
</tr>
</tbody>
</table>

The term expected residual returns refers to the expected residual returns based on fair value (using fair value as the benchmark), which in this Example is $26.667 million. Expected variability is a measure of total variability in either direction. It is the sum of the absolute values of the expected losses and expected residual returns.

Example A.2: Expected Variability in Cash Flows from Aircraft Operations

The following table illustrates how expected losses (negative variability) and expected residual returns (positive variability) are calculated based on the facts in Example A.1 involving the operations of an aircraft over a five-year period (see Table 1).

<table>
<thead>
<tr>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>E</th>
<th>F</th>
<th>G</th>
</tr>
</thead>
<tbody>
<tr>
<td>$6,247</td>
<td>$27,812</td>
<td>15%</td>
<td>$32,733</td>
<td>$(4,921)</td>
<td>$ (738)</td>
<td>$75</td>
</tr>
<tr>
<td>6,909</td>
<td>30,759</td>
<td>20%</td>
<td>32,733</td>
<td>(1,974)</td>
<td>395</td>
<td>508</td>
</tr>
<tr>
<td>7,409</td>
<td>32,985</td>
<td>30%</td>
<td>32,733</td>
<td>252</td>
<td></td>
<td>$75</td>
</tr>
<tr>
<td>7,809</td>
<td>34,765</td>
<td>25%</td>
<td>32,733</td>
<td>2,032</td>
<td>508</td>
<td>550</td>
</tr>
<tr>
<td>8,587</td>
<td>38,228</td>
<td>10%</td>
<td>32,733</td>
<td>5,495</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>100%</strong></td>
<td></td>
<td></td>
<td><strong>$(1,133)</strong></td>
<td></td>
<td><strong>$1,133</strong></td>
<td></td>
</tr>
</tbody>
</table>
Present value is determined based on a five-year annuity of the amount in column A discounted at a risk-free rate of 4%.

From Example A.1 Table 1, column D.

A.011 There is a direct relationship between the rate of return for a given asset and the variability that arises when calculating expected cash flows. The greater the rate of return, the greater the variability in expected cash flows for the asset.

Example A.3: Expected Losses and Expected Residual Returns from a Business Jet

To illustrate the components of an entity’s expected losses and expected residual returns, the following example builds on Examples A.1 and A.2.

Description of the Arrangement

Assume the following:

- Company BJ is an LLC formed to invest in a business jet. The jet has a fair value of $80 million. Company BJ plans to operate the business jet for five years and then sell it. There are two members in the LLC, one passive member and a managing member. The managing member receives a carried interest of 2% in the LLC and the passive member receives a carried interest of 98% in the LLC. The members contribute total capital of $16 million in cash – the managing member contributes $7.51 million and the passive member contributes $8.49 million.

- Because the LLC’s governing provisions are the functional equivalent of a limited partnership (i.e., the LLC is similar to a limited partnership) and because the passive member lacks substantive kick-out rights or participating rights, the LLC lacks the characteristic in ASC subparagraph 810-10-15-14(b)(1)(ii) (i.e., the members lack the power, through voting rights or similar rights, to direct the activities that most significantly impact the LLC’s economic performance) and, therefore, the LLC is a VIE.

- A single independent lender provides financing for the remainder of the acquisition price of the aircraft ($64 million). The debt is recourse only to the aircraft and the interest rate on the debt is 5.5% per annum.

- Company BJ obtains a guarantee from an independent third-party residual value guarantor that the value of the aircraft will be at least $51.22 million at the end of five years. An annual guarantee fee of $456,000 is payable to the guarantor by the LLC over the five-year period of the guarantee.
• Members of Company BJ share the net income or losses of the company and any capital appreciation or depreciation on the aircraft in proportion to their respective carried ownership percentages.

• The managing member will earn a series of fees for services provided to Company BJ, including management of the aircraft and general management of the company and all of its affairs. These fees are set at 43% of net income before payment of the managing member’s fees and guarantee fees. For this example, fees paid to the managing member are considered a variable interest in the LLC (e.g., the arrangement includes terms not customarily present in arrangements for similar services negotiated at arm’s length).

• Company BJ expects to sell the aircraft at the end of five years, use the proceeds to repay the debt, and distribute the remaining proceeds to the members.

• For ease of illustration, the risk-free rate and credit-adjusted risk-free rate are assumed to equal 4%.

Illustration

Example A.2 Table 2 presented Company BJ’s expected cash flows from operations, excluding variable interests, during its five-year operating term. This is a component of the entity’s expected losses and expected residual returns described in ASC Section 810-10-20. Estimated cash flows from operations have not been reduced to reflect fees paid to the managing member (43% of net income before payment of the managing member’s fees and guarantee fees), fees paid to the guarantor of $456,000 per year, or annual interest payments of $3.52 million to the lender. All of those items pertain to variable interests in the entity, as discussed further in Section 3. Fees paid to the guarantor will reduce net income, but will increase the cash flows from disposition of the aircraft (reducing the variability in overall cash flows of the entity) and are, therefore, excluded from the entity-level calculation of expected cash flows so that the variability inherent in the entity’s assets (excluding the guarantee) can be determined. Fees to the managing member reduce variability in overall cash flows of the entity because they are determined as a percentage of net income before payment of the fees. Finally, debt to the lender also is a variable interest in the entity and, therefore, interest payments to the lender are excluded from the calculation of variability in cash flows from operations. Table 2 (Example A.2) is reproduced here for convenience:
Table 2
Cash Flows From Aircraft Operations
(Dollars in Thousands)

<table>
<thead>
<tr>
<th>A</th>
<th>B²</th>
<th>C</th>
<th>D³</th>
<th>E = B - D</th>
<th>F = C × E</th>
<th>G = C × E</th>
</tr>
</thead>
<tbody>
<tr>
<td>$6,247</td>
<td>$27,812</td>
<td>15%</td>
<td>$32,733</td>
<td>$(4,921)</td>
<td>$ (738)</td>
<td></td>
</tr>
<tr>
<td>6,909</td>
<td>30,759</td>
<td>20%</td>
<td>32,733</td>
<td>(1,974)</td>
<td>(395)</td>
<td></td>
</tr>
<tr>
<td>7,409</td>
<td>32,985</td>
<td>30%</td>
<td>32,733</td>
<td>252</td>
<td></td>
<td>$75</td>
</tr>
<tr>
<td>7,809</td>
<td>34,765</td>
<td>25%</td>
<td>32,733</td>
<td>2,032</td>
<td></td>
<td>508</td>
</tr>
<tr>
<td>8,587</td>
<td>38,228</td>
<td>10%</td>
<td>32,733</td>
<td>5,495</td>
<td></td>
<td>550</td>
</tr>
<tr>
<td>100%</td>
<td></td>
<td></td>
<td></td>
<td>$(1,133)</td>
<td>$1,133</td>
<td></td>
</tr>
</tbody>
</table>

¹ Represents cash basis net income excluding fees paid to the managing member (43% of net income before payment of the managing member’s fees and guarantee fees), annual interest payments on $64 million ($3.52 million per year), and guarantee fees ($456,000 per year).
² Present value is determined based on a five-year annuity of the amount in column A discounted at a risk-free rate of 4%.
³ From Example A.1 Table 1, column D.

Table 3 presents Company BJ’s expected cash flows from the sale of the aircraft at the end of the five-year operating term of the LLC. The variability in those cash flows must be considered together with the variability in cash flows from operations, excluding variable interests, to determine the variability in the fair value of the entity’s net assets, excluding variable interests as required by ASC Section 810-10-20. Proceeds from the sale of the aircraft exclude amounts paid under the residual value guarantee, which is a variable interest as discussed earlier.

Table 3
Cash Flows From Sale of Aircraft
(Dollars in Thousands)

<table>
<thead>
<tr>
<th>A</th>
<th>B¹</th>
<th>C</th>
<th>D²</th>
<th>E = B - D</th>
<th>F = C × E</th>
<th>G = C × E</th>
</tr>
</thead>
<tbody>
<tr>
<td>$34,760</td>
<td>$28,570</td>
<td>15%</td>
<td>$47,267</td>
<td>$(18,697)</td>
<td>$(2,805)</td>
<td>$(875)</td>
</tr>
<tr>
<td>52,185</td>
<td>42,892</td>
<td>20%</td>
<td>47,267</td>
<td>2,817</td>
<td>$845</td>
<td></td>
</tr>
<tr>
<td>60,935</td>
<td>50,084</td>
<td>50%</td>
<td>47,267</td>
<td>6,926</td>
<td>1,731</td>
<td></td>
</tr>
<tr>
<td>65,935</td>
<td>54,193</td>
<td>25%</td>
<td>47,267</td>
<td>11,856</td>
<td>1,104</td>
<td></td>
</tr>
<tr>
<td>70,935</td>
<td>58,303</td>
<td>10%</td>
<td>47,267</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>100%</td>
<td></td>
<td></td>
<td></td>
<td>$(3,680)</td>
<td>$3,680</td>
<td></td>
</tr>
</tbody>
</table>
1 Present value is determined as the amount in column A received at the end of five years discounted at a risk-free rate of 4%.
2 Calculation is illustrated in Example A.1 Table1.

Table 4  
Summary of Expected Losses and Residual Returns  
(Dollars in Thousands)

<table>
<thead>
<tr>
<th>Expected Variability</th>
<th>Expected Losses</th>
<th>Expected Residual Returns</th>
</tr>
</thead>
<tbody>
<tr>
<td>in cash flows from operations (from Table 2)</td>
<td>$(1,133)</td>
<td>$1,133</td>
</tr>
<tr>
<td>in fair value of assets (from Table 3)</td>
<td>(3,680)</td>
<td>3,680</td>
</tr>
<tr>
<td>Total Expected Losses and Expected Residual Returns</td>
<td>$(4,813)</td>
<td>$4,813</td>
</tr>
</tbody>
</table>

The expected cash flows related to the entity’s net income or loss, excluding variable interests, and the fair value of its net assets, excluding variable interests, should be considered in the aggregate to determine the entity’s expected losses and expected residual returns.
Table 5 reconciles the expected cash flows presented above to the fair value of the LLC’s only asset (the business jet).

Table 5
Reconciliation of Expected Cash Flows to Fair Value of Entity’s Assets
(Dollars in Thousands)

Expected Cash Flows From:

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operations (from Table 2)¹</td>
<td>$32,733</td>
</tr>
<tr>
<td>Disposition of aircraft (from Table 3)²</td>
<td>47,267</td>
</tr>
<tr>
<td><strong>Total Fair Value of Assets</strong></td>
<td><strong>$80,000</strong></td>
</tr>
</tbody>
</table>

¹ Represents cash basis net income excluding fees paid to the managing member (43% of net income before payment of the managing member’s fees and guarantee fees), annual interest payments on $64 million ($3.52 million per year), and guarantee fees ($456,000 per year), all of which pertain to variable interests. See Example A.2 for additional information.

² Excludes amounts recoverable under the residual value guarantee as discussed previously.

Based on these calculations, the level of equity that is required by the entity to demonstrate that its equity is sufficient to finance its own operations is any amount greater than $4.813 million. Although the 10% presumption in ASC paragraph 810-10-25-45 would indicate that the entity needs equity of at least $8 million (based on assets of $80 million), that presumption is overcome because the entity’s expected losses are less than 10% of its assets. The entity has equity at risk with a fair value of $16 million. However, the entity is a VIE because the members lack the power, through voting rights or similar rights, to direct the activities that most significantly impact the LLC’s economic performance, based on the application of ASC subparagraph 810-10-15-14(b)(1)(ii) for limited partnerships and similar entities.

**Interests in Specified Assets of a Variable Interest Entity**

A.012 As discussed in Section 3, the FASB decided that interests in specified assets of an entity are not considered variable interests in the entity provided that the fair value of the specified assets represents no more than 50% of the fair value of the entity’s total assets and the holder of the interests in specified assets does not have a variable interest in the overall VIE (unless the variable interest is insignificant or has little or no variability). The FASB also decided that expected losses and expected residual returns from variable interests in specified assets should be excluded from the expected losses and expected residual returns of the entity when considering the adequacy of the entity’s equity and the characteristics of that equity for purposes of determining whether the entity is a
VIE. See Section 3 and ASC paragraphs 810-10-25-55 through 25-56 for guidance on interests in specified assets.

**Example A.4: Expected Losses and Expected Residual Returns in Specified Assets**

To illustrate the effects of the guidance about interests in specified assets on the calculation of expected losses and expected residual returns, the following example builds on Examples A.1 through A.3.

**Description of the Arrangement**

Assume the following in addition to the assumptions in Example A.3 about expected losses and expected residual returns in an LLC formed to invest in a business jet:

- Company BJ acquires an aircraft hangar in which to house its business jet. The hangar has room for BJ’s business jet and nine other planes. The aircraft hangar has a fair value of $5 million. Company BJ plans to lease the hangar to tenants for five years and then sell it.
- The acquisition price of the hangar is funded by equity contributions from the members of $1 million in cash (provided in proportion to the members’ carried interests of 2% and 98%, respectively) and general recourse financing (with the hangar provided as collateral) from a single independent lender of $4 million with an interest rate of 4% per annum.
- Company BJ leases the hangar to Aircraft Maintenance Company M for five years for a fixed rental rate and takes back a sublease for 10% of the hangar space for the same period.
- As part of the lease agreement, Company BJ obtains a residual value guarantee from Company M that the value of the hangar will be at least $4.624 million at the end of five years. BJ also gives Company M a purchase option to acquire the hangar for $4.624 million at the end of five years.
- Members of Company BJ share the net income or losses from managing the hangar in proportion to their respective capital ownership percentages. The managing member does not receive a fee in connection with the operations of the hangar.
- Company BJ expects to sell the hangar at the end of five years, use the proceeds to repay the debt, and distribute the remaining proceeds to the members.
Illustration

Table 6 presents Company BJ’s expected cash flows from managing the hangar’s operations during the five-year operating lease term. Estimated cash flows presented have not been reduced for annual interest payments of $160,000 to the lender. Debt to the lender is a variable interest in the entity rather than an interest in specified assets and, therefore, interest payments to the lender are excluded from the calculation of variability in cash flows from operations. The cash flows used to determine the entity’s expected losses and expected residual returns should be determined based on the cash flows that represent the fair value of the entity’s net assets. Accordingly, those cash flows should exclude interest expense on debt of the entity if the debt is a variable interest in the entity.

<table>
<thead>
<tr>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>E</th>
<th>F</th>
<th>G</th>
</tr>
</thead>
<tbody>
<tr>
<td>$250</td>
<td>$1.113</td>
<td>15%</td>
<td>$1.200</td>
<td>$(87)</td>
<td>$(13)</td>
<td></td>
</tr>
<tr>
<td>260</td>
<td>1.157</td>
<td>20%</td>
<td>1.200</td>
<td>(43)</td>
<td>(8)</td>
<td>$</td>
</tr>
<tr>
<td>270</td>
<td>1.202</td>
<td>30%</td>
<td>1.200</td>
<td>2</td>
<td></td>
<td></td>
</tr>
<tr>
<td>280</td>
<td>1.247</td>
<td>25%</td>
<td>1.200</td>
<td>47</td>
<td>12</td>
<td></td>
</tr>
<tr>
<td>290</td>
<td>1.291</td>
<td>10%</td>
<td>1.200</td>
<td>91</td>
<td>9</td>
<td></td>
</tr>
<tr>
<td>100%</td>
<td></td>
<td></td>
<td></td>
<td>$(21)</td>
<td>$21</td>
<td></td>
</tr>
</tbody>
</table>

1 Present value is determined based on a five-year annuity of the amount in column A discounted at a risk-free rate of 4%.
2 Calculation is illustrated in Example A.1 Table 1.
Table 7 presents Company BJ’s expected cash flows from the sale of the hangar at the end of the five-year lease term.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>$4,100</td>
<td>$3,370</td>
<td>15%</td>
<td>$3,800</td>
<td>$(430)</td>
<td>$ (65)</td>
<td>100%</td>
</tr>
<tr>
<td>4,400</td>
<td>3,616</td>
<td>20%</td>
<td>3,800</td>
<td>(184)</td>
<td>(37)</td>
<td>7</td>
</tr>
<tr>
<td>4,650</td>
<td>3,822</td>
<td>30%</td>
<td>3,800</td>
<td>22</td>
<td></td>
<td>52</td>
</tr>
<tr>
<td>4,875</td>
<td>4,007</td>
<td>25%</td>
<td>3,800</td>
<td>207</td>
<td>52</td>
<td>43</td>
</tr>
<tr>
<td>5,150</td>
<td>4,233</td>
<td>10%</td>
<td>3,800</td>
<td>433</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

1 Present value is determined as the amount in column A received at the end of five years discounted at a risk-free rate of 4%.

2 Calculation is illustrated in Example A.1 Table 1.

Table 8 presents expected cash flows associated with the hangar guarantee obligation.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>$(524)</td>
<td>$(430)</td>
<td>15%</td>
<td>$(65)</td>
</tr>
<tr>
<td>(224)</td>
<td>(184)</td>
<td>20%</td>
<td>(37)</td>
</tr>
<tr>
<td>-</td>
<td>-</td>
<td>65%</td>
<td>-</td>
</tr>
</tbody>
</table>

1 Present value is determined as the amount in column A received at the end of five years discounted at a risk-free rate of 4%.
Table 9 presents expected cash flows associated with the hangar purchase option.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 26</td>
<td>$ 22</td>
<td>30%</td>
<td>$ 7</td>
</tr>
<tr>
<td>251</td>
<td>207</td>
<td>25%</td>
<td>52</td>
</tr>
<tr>
<td>526</td>
<td>433</td>
<td>10%</td>
<td>43</td>
</tr>
<tr>
<td>-</td>
<td>-</td>
<td>35%</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td></td>
<td>100%</td>
<td>$102</td>
</tr>
</tbody>
</table>

1 Present value is determined as the amount in column A received at the end of five years discounted at a risk-free rate of 4%.

Because the fair value of the hangar is less than 50% of the fair value of Company BJ’s total assets ($5 million ÷ $85 million = 6%), the residual value guarantee and purchase option with respect to the hangar represent interests in specified assets rather than variable interests in the entity. The residual value guarantee absorbs all of the expected losses from the disposition of the hangar as shown in Table 8, and the purchase option receives the right to all of the expected residual returns from the disposition of the hangar as shown in Table 9. For ease of illustration, this example assumes that there is no credit risk related to the guarantee and, therefore, none of the expected losses contractually absorbed by the guarantor are reflected as expected losses of the entity. Generally, the entity would retain some of the credit risk with respect to the guarantee.
Table 10 presents the LLC’s expected cash flows from disposition of the hangar inclusive of the interests in specified assets (i.e., the residual value guarantee and the purchase option).

<table>
<thead>
<tr>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>E = B - D</th>
<th>F = C × E</th>
<th>G = C × E</th>
</tr>
</thead>
<tbody>
<tr>
<td>$4,624</td>
<td>$3,800</td>
<td>15%</td>
<td>$3,800</td>
<td>$ -</td>
<td>$ -</td>
<td>$ -</td>
</tr>
<tr>
<td>4,624</td>
<td>3,800</td>
<td>20%</td>
<td>3,800</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>4,624</td>
<td>3,800</td>
<td>30%</td>
<td>3,800</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>4,624</td>
<td>3,800</td>
<td>25%</td>
<td>3,800</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>4,624</td>
<td>3,800</td>
<td>10%</td>
<td>3,800</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>100%</td>
<td>$ -</td>
<td>$ -</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

1 Amount is constant because of the residual value guarantee and purchase option.
2 Present value is determined as the amount in column A received at the end of five years discounted at a risk-free rate of 4%.
3 Calculation is illustrated in Example A.1 Table 1

Table 11 summarizes the components of the LLC’s expected losses and expected residual returns inclusive of the interests in specified assets.

<table>
<thead>
<tr>
<th>Expected Losses</th>
<th>Expected Residual Returns</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected losses and residual returns from aircraft (from Table 4)</td>
<td>$(4,813)</td>
</tr>
<tr>
<td>Expected variability in hangar net income or loss (from Table 6)</td>
<td>(21)</td>
</tr>
<tr>
<td>Expected variability in fair value of hangar (from Table 10)</td>
<td>-</td>
</tr>
<tr>
<td>Total Expected Losses and Expected Residual Returns</td>
<td>$(4,834)</td>
</tr>
</tbody>
</table>
The expected cash flows related to the entity’s net income or loss, excluding variable interests, and the fair value of its net assets, excluding variable interests, should be considered in the aggregate to determine the entity’s expected losses and expected residual returns. Because the analysis focuses on cash flows, and because the cash flows considered exclude those that pertain to variable interests, the analysis is not the same as the U.S. GAAP concept of net income.

Table 12 presents a reconciliation of the expected cash flows presented above to the fair value of the LLC’s only assets (the business jet and the hangar).

<table>
<thead>
<tr>
<th>Table 12</th>
<th>Reconciliation of Expected Cash Flows to Fair Value of Entity’s Assets</th>
<th>(Dollars in Thousands)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected Cash Flows From:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net income or loss – aircraft (from Table 2 - Example A.3)¹</td>
<td>$32,733</td>
<td></td>
</tr>
<tr>
<td>Net income or loss – hangar (from Table 6)²</td>
<td>1,200</td>
<td></td>
</tr>
<tr>
<td>Disposition of aircraft (from Table 3 - Example A.3)</td>
<td>47,267</td>
<td></td>
</tr>
<tr>
<td>Disposition of hangar (from Table 7)</td>
<td>3,800</td>
<td></td>
</tr>
<tr>
<td><strong>Total Fair Value of Assets</strong></td>
<td><strong>$85,000</strong></td>
<td></td>
</tr>
</tbody>
</table>

¹ Excludes fees paid to the managing member (43% of net income before payment of the managing member’s fees and guarantee fees), annual interest payments on $64 million ($3.52 million per year), and fees paid to the guarantor of $456,000 per year.

² Excludes annual interest payments on $4 million ($160,000 per year).

Based on the calculations summarized in Table 11, the level of equity required by the entity to demonstrate that its equity is sufficient to finance its own operations is any amount greater than $4.834 million. Although the 10% presumption in ASC paragraph 810-10-25-45 would indicate that the entity needs equity of at least $8.5 million (based on assets of $85 million), that presumption is overcome because the entity’s expected losses are less than 10% of its assets. In addition, even though the entity has equity at risk with a fair value of $17 million, it is a VIE because the members lack the power, through voting rights or similar rights, to direct the activities that most significantly impact the LLC’s economic performance, based on the application of ASC subparagraph 810-10-15-14(b)(1)(ii) for limited partnerships and similar
entities. We believe that for many entities similar to limited partnerships, the provisions of ASC subparagraph 810-10-15-14(b)(1)(ii) are more likely to cause the entity to be a VIE than are the provisions of ASC subparagraph 810-10-15-14(a).

**Question A.1: Consideration of an Entity’s Design in Calculating Expected Losses and Expected Residual Returns**

Will the present value of an entity’s expected cash flows equal the fair value of the entity’s net assets, exclusive of variable interests?

**Interpretive Response:** Not necessarily. As discussed in Section 3 and ASC paragraphs 810-10-25-21 through 25-29, the specific risks that an entity was designed to create and distribute to its interest holders must be identified to determine the entity’s expected losses, expected residual returns, and variable interests. The by design approach may result in the exclusion from an entity’s expected losses and expected residual returns of variations in cash flows that affect the fair value of an entity’s net assets, exclusive of variable interests, because those variations do not arise from the risks that the entity is designed to create and distribute to its interest holders. For example, variations in cash flows arising from interest rate risk may affect the fair value of an entity’s net assets but may be excluded in calculating the entity’s expected cash flows, expected losses, and expected residual returns because interest rate risk is not a risk that the entity is designed to create and distribute to its interest holders.

As a result of the by design approach for determining an entity’s expected losses and expected residual returns, the present value of an entity’s expected cash flows may not necessarily equal the fair value of its net assets exclusive of variable interests. However, generally it should be possible to reconcile the present value of an entity’s expected cash flows under the by design guidance to the fair value of the entity’s net assets exclusive of variable interests. The objective of the Concepts Statement 7 expected cash flow approach is to measure fair value using probability-weighted discounted cash flows. Accordingly, when all of the risks that affect an entity are included in determining its probability-weighted expected cash flows, the present value of those expected cash flows should approximate the fair value of the entity’s net assets (exclusive of variable interests). Comparing those expected cash flows with the expected cash flows determined under the by design approach should make it possible to evaluate whether the difference is commensurate with the effects of the risks that the entity is not designed to create and pass along to its variable interest holders. In addition, comparing the entity-level expected cash flows to the expected cash flows attributable to the entity’s variable interests under the by design approach may help to ensure that the entity-level expected cash flows have been appropriately determined. In many situations, an iterative approach may be necessary to determine the possible cash flow scenarios and their respective probability weightings that result in the present value of
Question A.2: Consideration of Interest Rate Risk in By Design Analysis of Variability

When should changes in market interest rates be considered a risk that an entity is designed to create and distribute to its interest holders in calculating the entity’s expected losses and expected residual returns?

Interpretive Response: Professional judgment is necessary to determine when the risk of changes in market interest rates is a risk that an entity is designed to create and distribute to its interest holders. The implementation guidance of ASC Subtopic 810-10 generally illustrates that interest rate risk is considered a risk the entity is designed to create and distribute to its interest holders when that risk causes variability in the entity’s cash flows available to its subordinated variable interests. For example, when interest rate risk affects the cash flows to be received from the disposition of assets with fixed interest rates before their maturity, ASC paragraph 810-10-25-33 indicates that such interest rate risk is strongly indicated as a risk that the entity was designed to create and pass along to its interest holders. See Section 3 for additional information on the consideration of interest rate risk in a by design analysis. Under the guidance in ASC paragraph 810-10-25-33, variability arising from fluctuations in market interest rates should be excluded from the calculation of an entity’s expected losses and expected residual returns if the entity was not designed to create and pass along that risk to its interest holders.

Question A.3: Effect of Guidance in ASC Topic 820 on Calculations of Expected Losses and Expected Residual Returns

Does the guidance in ASC Topic 820 related to fair value measurements apply to calculations of expected losses and expected residual returns under ASC Subtopic 810-10?

Background

The guidance in ASC Topic 820 (previously FASB Statement No. 157, Fair Value Measurements) provides a framework for most U.S. GAAP fair value measurements and disclosure requirements related to fair value measurements. ASC paragraph 820-10-55-5 indicates that a risk premium (i.e., the price market participants would demand for bearing uncertainty in uncertain cash flows) is an element of a fair value measurement of an asset or liability. A risk premium is reflected as an adjustment of the discount rate in a discounted cash flow analysis under either the traditional or probability-weighted expected cash flow approaches.
Interpretive Response: No. The guidance in ASC Subtopic 810-10 on expected loss calculations incorporates by reference the guidance in Concepts Statement 7, which was not amended by Statement 157. In addition, expected cash flows, expected losses, and expected residual returns under ASC Subtopic 810-10 do not necessarily represent fair value measurements. As discussed in paragraph A.009, ASC Subtopic 810-10 requires the present value of expected cash flows to be determined using a risk-free discount rate. A risk-free discount rate excludes any risk premium. However, although the compensation demanded by market participants for bearing the risk of uncertain cash flows may not be included in the ASC Subtopic 810-10 calculation of expected losses and expected residual returns, the uncertainty in the timing and amount of the cash flows is reflected in the probability weighting of the expected cash flows.

Question A.4: Calculating Expected Losses and Expected Residual Returns When an Entity Has an Indefinite Life

How should expected losses and expected residual returns be calculated for an entity with an indefinite life (i.e., an entity that expects to continue operating with no definite exit plan)?

Interpretive Response: We believe it is acceptable to calculate expected losses and expected residual returns for an entity with an indefinite life by projecting operating cash flows for a judgmentally determined number of years (e.g., five years) followed by an assumed terminal value obtained upon a theoretical disposition of the entity’s net assets exclusive of variable interests. Where the terminal value is a function of the operating cash flows in a specified number of years preceding the theoretical disposition (e.g., a multiple of the last year of projected cash flows from operations), the terminal value scenarios would be based on the projected scenarios used in the calculation of the expected cash flows from the entity’s operations.

Question A.5: Number of Possible Cash Flow Scenarios in Calculating Expected Losses and Expected Residual Returns

Is there a minimum number of possible cash flow scenarios that should be included in calculating an entity’s expected losses and expected residual returns?

Interpretive Response: ASC Subtopic 810-10 does not require a minimum number of possible outcomes to be included in a calculation of expected losses and expected residual returns. Determining the minimum number of cash flow scenarios to be included in calculating an entity’s expected losses and expected residual returns requires professional judgment based on the entity’s specific facts and circumstances. However, these calculations are required to comply with the guidance in Concepts Statement 7 for expected cash flow.
calculations under which the uncertainty in the timing and amount of the cash flows is reflected in the probability assigned to individual projected cash flows. It is important to remember that as the number of cash flow scenarios included in the calculation of expected losses and expected residual returns increases, the level of probability (and the relative effect on the overall result) assigned to each individual scenario will necessarily decrease. Nevertheless, we believe a calculation that includes only a very limited number of scenarios (e.g., base case, best case, and worst case) generally will not appropriately quantify the entity’s expected losses and expected residual returns as required under ASC Subtopic 810-10. In general, we believe there is a direct relationship between the relative complexity of an entity’s assets and the number of cash flow scenarios that should be included in calculating the entity’s expected losses and expected residual returns. That is, as the relative complexity of an entity’s assets increases it generally will be necessary to include a greater number of cash flow scenarios in the calculation of the entity’s expected losses and expected residual returns. It is generally not necessary to add additional cash flow scenarios to a calculation of expected losses and expected residual returns if doing so would not affect the determination of whether the entity is a VIE.

In practice, we have seen expected loss calculations fall into two general categories. The approach in one category is not necessarily preferable to the approach in the other; rather the selection of the appropriate approach to use depends on the entity and its specific facts and circumstances. Approaches that do not fall into either of these two general categories may also achieve the objectives of ASC Subtopic 810-10 depending on the relevant facts and circumstances.

The first category of calculations, which is relatively simple, typically begins with a base case or most likely outcome to which additional cash flow scenarios are added based on changes to the assumptions in the base case. Probabilities are assigned to each cash flow scenario (including the base case) to calculate the entity’s expected losses and expected residual returns. The calculations in this category generally include a much smaller number of cash flow scenarios than the calculations in the second category.

A second more complicated category of calculations that we have seen in practice uses option modeling techniques (e.g., a Monte Carlo simulation) to calculate an entity’s expected losses and expected residual returns. The use of option modeling techniques generally requires valuation or other specialists with the requisite professional skills to be involved in preparing or overseeing the preparation of the calculations and ensuring that their results are consistent with the requirements of ASC Subtopic 810-10. We have most frequently seen such calculations in entities that predominantly comprise financial assets. Option modeling techniques may generate hundreds of thousands of cash flow scenarios that are used to calculate the entity’s expected losses and expected residual returns.
Question A.6: Methods of Measuring Expected Losses and Expected Residual Returns

Are there different acceptable methods for measuring an entity’s expected losses and expected residual returns?

Interpretive Response: Yes. We are aware of two primary methods used in practice to measure an entity’s expected cash flows, expected losses, and expected residual returns: the fair value method and the cash flow method. The methods differ mainly in their treatment of changes in interest rates and the resulting effect on projected cash flows and discount rates. Each method is described in more detail below.

**Fair Value Method**

The objective of the fair value method is to measure an entity’s expected cash flows, expected losses, and expected residual returns based on the relative fair value of its cash flows. Under the fair value method, multiple possible cash flow outcomes are projected under a variety of interest rate environments and discounted using the yield curve from those respective environments to calculate the present value of the entity’s expected cash flows. Changes in fair value that do not affect cash flows to the entity’s variable interests are ignored under the fair value method (the same cash flows generally are used in both the fair value method and the cash flow method, but different discount rates are used under the two methods.)

Under the fair value method, projected cash flows for a fixed-rate debt security would be constant except as a result of credit losses, but even in scenarios where no credit losses are expected, the security would cause variability because the cash flows would be discounted at different rates due to the different yield curves in various possible interest rate environments. Conversely, projected cash flows for a variable-rate debt security would be variable even where no credit losses are expected, but in those scenarios the security would cause little or no variability because the cash flows would be discounted at rates that reflect the different yield curves giving rise to the variable cash flows in various possible interest rate environments.

**Cash Flow Method**

The objective of the cash flow method is to measure an entity’s expected cash flows, expected losses, and expected residual returns based on the absolute value of its cash flows. Under the cash flow method, multiple possible cash flow outcomes are projected under a variety of interest rate environments and discounted using only the yield curve that exists at the date the calculation is performed to calculate the present value of the entity’s expected cash flows. Changes in fair value that do not affect cash flows to the entity’s variable interests are ignored under the cash flow method (the same cash flows...
generally are used in both the fair value method and the cash flow method, but different discount rates are used under the two methods.)

Under the cash flow method, projected cash flows for a fixed-rate debt security would be constant except as a result of credit losses, and where no credit losses are expected, the security would cause no variability because the cash flows would be discounted at a single discount rate using the yield curve that exists at the date the calculation is performed. Conversely, projected cash flows for a variable-rate debt security would be variable even where no credit losses are expected and the security would cause variability because the cash flows would be discounted at a single discount rate using the yield curve that exists at the date the calculation is performed.

A variation of the cash flow method that also is used in practice is designed to eliminate interest rate risk as a creator of variability in the calculation of expected losses and expected residual returns. Under this method, which is a hybrid of the cash flow and fair value methods, projected cash flows from fixed-rate interest-bearing assets are discounted at a single discount rate using the yield curve that exists at the date the calculation is performed, whereas projected cash flows from variable-rate interest-bearing assets are discounted at rates that reflect the different yield curves giving rise to the variable cash flows in various possible interest rate environments. The result is that there is little or no variability in the present value of expected cash flows due to changes in interest rates.

**Application of Alternative Methods**

The existence of alternative methods used to measure expected losses and expected residual returns was one of the reasons that two FASB members, Leslie Seidman and George Batavick, dissented to the issuance of FASB Interpretation No 46(R), *Consolidation of Variable Interest Entities*. In their dissent these Board members noted that:

…there is currently a lack of clarity surrounding the application of the expected loss-return test, which is the gateway in determining whether an entity is a variable interest entity and the key quantitative test for identifying who should consolidate an entity. The Board is aware that different approaches exist that result in different conclusions about whether an entity is a variable interest entity and also whether a reporting entity is the primary beneficiary. Mr. Batavick and Ms. Seidman find it troubling that entities with the same contractual structures could reach different conclusions about whether the entity is a variable interest entity and who should consolidate it. They believe the Board should provide more guidance for calculating expected losses and expected residual returns so that the new consolidation model will be applied with a high degree of consistency.

The FASB voted to finalize the VIE consolidation guidance in FIN 46(R) without addressing these Board members’ concerns and to date has provided no
additional guidance to narrow the methodologies used in practice to measure expected losses and expected residual returns.

We believe that a reporting enterprise should use a single method to measure expected losses and expected residual returns for any given entity. However, because different entities have different designs, we believe reporting enterprises need not use the same method to measure expected losses and expected residual returns for all entities. To mitigate concerns about inconsistencies in how expected losses and expected residual returns are measured for similar entities, we believe a reporting enterprise should apply a consistent method to measure expected losses and expected residual returns to entities with similar designs. That is, we believe the selection of the method used to measure expected losses and expected residual returns is accounting policy election that depends on the design of the entity.

Question A.7: Expected Losses for Profitable Entities

Can an entity that has no history of net losses and expects to continue to be profitable in the foreseeable future have expected losses and be a variable interest entity?

Interpretive Response: Yes. This question is addressed by Example 2 of the implementation guidance for VIEs in ASC Section 810-10-55 (previously FASB Staff Position FIN 46(R)-2, “Calculation of Expected Losses under FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities”), and the definition of expected losses in ASC Section 810-10-20, which are reproduced below.

Excerpts from ASC Subtopic 810-10

Example 2: Calculation of Expected Losses if There Is No History of, nor Future Expectation of, Net Losses

55-50 This Example illustrates the calculation of expected losses if a legal entity has no history of net losses and expects continued profitability. This Example has the following assumptions:

(a) On January 1, 2004, Entity A is formed to purchase a building, 95 percent of which is financed by debt and 5 percent by equity. The lenders will have recourse only to the building in the event that Entity A does not make the required debt payments.

(b) On the same day, Entity B enters into a five-year market-rate lease for the building from Entity A that includes a guarantee of a portion of the building’s residual value. The present value of the minimum lease payments, including the residual value guarantee, is less than 90 percent of the fair value of the building.
There are no other interests in Entity A.

The appropriate discount rate is assumed to be 5 percent.

The estimated annual outcomes in the Example include both estimated cash flows and the estimated fair value of Entity A’s assets to be distributed to variable interest holders in lieu of cash, exclusive of cash flows (or flows of other assets) to and from variable interests. The guarantee is a variable interest in Entity A because it is an interest in assets with a fair value that is more than half of the total fair value of Entity A’s assets. Therefore, losses absorbed by the residual value guarantee are losses of Entity A and are included in the outcomes used to calculate expected losses. For calculation simplicity, the estimated outcomes, which include both cash flows and changes in the fair value of Entity A’s net assets, and related probabilities are assumed to be the same each year of the five-year lease, and at the end of the lease, the carrying value of the building is assumed to be its fair value.

The following table shows the January 1, 2004, calculation of the expected outcome at the inception of the guarantee identified as a variable interest. The fair value of the expected outcome is assumed to be equal to the sum of the present values of probability-weighted estimated annual outcomes for the five-year lease term, excluding the effects of the residual value guarantee. Any variation in estimated outcomes, as compared to the expected outcome, represents a change to the value of Entity A’s net assets exclusive of variable interests from the calculation-date value of those net assets.

<table>
<thead>
<tr>
<th>Estimated Annual Outcomes (a)</th>
<th>Probability</th>
<th>Expected Annual Outcome</th>
<th>Fair Value of Expected Five-Year Outcomes (b)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ (10,000)</td>
<td>5.0%</td>
<td>$ (500)</td>
<td>$ (2,165)</td>
</tr>
<tr>
<td>(5,000)</td>
<td>10.0%</td>
<td>(500)</td>
<td>(2,165)</td>
</tr>
<tr>
<td>-</td>
<td>20.0%</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>10,000</td>
<td>50.0%</td>
<td>5,000</td>
<td>21,648</td>
</tr>
<tr>
<td>50,000</td>
<td>15.0%</td>
<td>7,500</td>
<td>32,471</td>
</tr>
<tr>
<td>100.0%</td>
<td></td>
<td>$ 11,500</td>
<td>$ 49,789</td>
</tr>
</tbody>
</table>

(a) Estimated outcomes include both estimated cash flows, exclusive of cash flows (or flows of other assets) to and from variable interests, and the estimated fair value of Entity A’s assets to be distributed to variable interest holders in lieu of cash.

(b) The fair value is assumed to be the sum of the present values of the expected outcomes for each year of the five-year period. Because of the simplifying assumption that the annual estimated outcomes and probabilities are the same for each year of the five-year period, the expected annual outcomes are treated as level annuities in the present value calculations to determine the fair value of the five-year expected outcomes.

The following table shows the calculation of expected losses as the negative variability from the fair value of the expected outcome. Note that the estimated annual outcomes of $0 and $10,000 contribute to expected losses although neither amount is negative. To the extent that an estimated outcome,
although positive, is less than the expected outcome, the legal entity will lose value in relation to its value based on the expected outcome. The following table illustrates the calculation of this expected loss as the fair value of the probability-weighted negative variations from the expected outcome. Expected losses include all such negative variations.

<table>
<thead>
<tr>
<th>Estimated Annual Outcomes</th>
<th>Present Value of Estimated Five-Year Outcomes (e)</th>
<th>Fair Value of Expected Five-Year Outcomes (from the table in the preceding paragraph)</th>
<th>Positive (Negative) Variation from Expected Value</th>
<th>Probability</th>
<th>Expected Losses</th>
<th>Residual Returns</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ (10,000)</td>
<td>$ (43,294)</td>
<td>$ 49,789</td>
<td>(93,083)</td>
<td>5.00%</td>
<td>$ (4,554)</td>
<td></td>
</tr>
<tr>
<td>(5,000)</td>
<td>(21,918)</td>
<td>49,789</td>
<td>(71,437)</td>
<td>10.0%</td>
<td>(7,144)</td>
<td></td>
</tr>
<tr>
<td>10,000</td>
<td>43,294</td>
<td>49,789</td>
<td>(49,789)</td>
<td>20.0%</td>
<td>(9,568)</td>
<td></td>
</tr>
<tr>
<td>50,000</td>
<td>216,473</td>
<td>49,789</td>
<td>(8,493)</td>
<td>50.0%</td>
<td>(3,247)</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>165,584</td>
<td></td>
<td>15.0%</td>
<td></td>
<td>$25,003</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>100.00%</td>
<td></td>
<td>$25,003</td>
<td>$25,003</td>
</tr>
</tbody>
</table>

(a) Because of the simplifying assumption that the annual estimated outcomes are the same for each year of the five-year period, the estimated annual outcomes are treated as level annuities in the calculation of the present value of estimated five-year outcomes.

55-54 Negative variations can occur without having a net loss reflected in any of the estimated outcomes. Consequently, a profitable VIE will have expected losses which must be considered in evaluating the sufficiency of equity-at-risk under paragraph 810-10-25-45(c).

20 Glossary

Expected Losses

A legal entity that has no history of net losses and expects to continue to be profitable in the foreseeable future can be a variable interest entity (VIE). A legal entity that expects to be profitable will have expected losses.

Question A.8: Consideration of Tax Benefits Received by Variable Interest Holders in Determining an Entity’s Expected Losses and Expected Residual Returns

Should the effect of tax benefits related to some or all of an entity’s assets be considered in determining the entity’s expected losses and expected residual returns if those tax benefits are received directly by the entity’s investors rather than by the entity itself?

Background

An affordable housing limited partnership is formed to develop and operate a multifamily housing project. Provided that a specified number of the housing units remain affordable for at least 15 years to tenants who earn 60% or less of the area median income, investors in the partnership are eligible for a 10-year federal income tax credit on their investment. The tax credits do not affect the
net income or cash flows of the limited partnership, but do affect the value of the property and the value of the investors' interests in the partnership.

**Interpretive Response:** It depends on the facts and circumstances. In general, if the tax benefits received directly by variable interest holders affect the fair value of the entity's assets, we believe that the effect of those benefits should be considered in calculating the entity’s expected losses and expected residual returns because the tax benefits affect the fair value of the entity’s related assets and the fair value of the investors’ interests in the entity. When an investor’s return on an investment results primarily from tax benefits (e.g., investments in affordable housing projects), we believe the tax benefits typically would affect the fair value of the entity’s assets. Where the direct tax effects to variable interest holders of their investments in an entity do not affect the fair value of the entity’s assets, we believe the variable interest holders’ tax effects generally should not be considered in calculating the entity’s expected losses and expected residual returns because the tax effects occur outside the entity. We understand the SEC staff also holds this view.

Indicators that an investor's return results primarily from tax benefits include, but are not limited to, the following:

- Without the tax benefits from the investment, the investor would incur a loss on its investment or its return would be substantially below market in relation to the risk of its investment;
- The investor has received a third-party guarantee (often from another variable interest holder) of the tax benefits to be received on its investment in the entity; and
- The acquisition cost of the investment is primarily determined based on the tax benefits it is projected to generate for the investor.

**ALLOCATING EXPECTED LOSSES AND EXPECTED RESIDUAL RETURNS TO VARIABLE INTERESTS**

**A.013** In applying the VIE consolidation guidance of ASC Subtopic 810-10, it may be necessary to determine the allocation of an entity’s expected losses and expected residual returns to the entity’s interest holders. For example, this may be necessary under ASC subparagraphs 810-10-15-14(b)(2) and 15-14(c), and ASC paragraph 810-10-25-38A. To determine the allocation of an entity’s expected losses and expected residual returns, the variable interest holders must consider the rights and obligations that their variable interests convey to them in relation to the variable interests of other parties. In practice there are two primary methods of performing this allocation, the **bottom-up approach** and the **top-down approach**. The appropriate methodology to use depends on the nature of the transaction structure and the way in which cash flows of the entity are shared among its variable interest holders. However, we believe the methodology used to perform these allocations should be applied consistently by a reporting enterprise to comparable transaction structures.
A.014 In relatively straightforward transaction structures, an acceptable allocation methodology may entail determining how the expected losses of the entity, if incurred as an actual loss, would be absorbed by the parties involved with the entity and how the expected residual returns of the entity, if realized as an actual return, would inure to the benefit of the parties involved with the entity. (This type of approach generally is referred to as a bottom-up approach.) Under the bottom-up approach, the entity’s expected losses and expected residual returns may not be allocated to all of its variable interest holders. For example, when an entity has issued debt but its expected losses do not exceed the fair value of its equity at risk, none of the entity’s expected losses would be allocated to the investors in its debt. We believe that to determine which variable interests represent an entity’s subordinated financial support (i.e., which interests will absorb some or all of the entity’s expected losses), ASC Section 810-10-20, ASC subparagraph 810-10-15-17(d)(3), and ASC paragraphs 810-10-55-23 and 55-24 suggest that the evaluation should be made using the bottom-up approach, because that guidance indicates that subordinated financial support may not include all of the entity’s variable interests.

A.015 Because of complexities inherent in the transaction structure or pattern of cash flow distribution to the variable interest holders, it often may be necessary to determine the variability in the fair value of each variable interest holder’s interest to allocate the entity-level expected losses and expected residual returns to variable interest holders. (This type of approach generally is referred to as a top-down approach.) For example, we believe a top-down approach to allocate an entity’s expected losses and expected residual returns is necessary in a transaction structure in which cash flows are separated into interest-only and principal-only strips, or in which an interest such as nonrecourse debt causes the cash flows of the entity not to be shared in a consecutive fashion or in proportion to the stated interests of investors. Under the top-down approach, an entity’s expected losses and expected residual returns are allocated to all of the entity’s variable interest holders.

A.016 The sum of the variability in the fair value of all of an entity’s variable interest holders’ interests usually will be greater than the entity-level variability. Therefore, in applying the top-down approach it usually will be necessary to allocate or reconcile the difference between the total variability in the individual variable interests to the entity-level variability. Although there is more than one methodology that could be used to reconcile the variability in the individual variable interests to that of the entity as a whole, one methodology that we believe is appropriate is the proportionate variability methodology. Under the proportionate variability methodology, each variable interest holder’s share of the entity-level variability in cash flows is determined as the ratio of the variability in the individual variable interest holder’s cash flows divided by the total variability in all variable interest holders’ cash flows. The proportionate variability allocation approach is illustrated in the following example, which builds on Examples A.2 through A.4.
Example A.5: Proportionate Variability Approach to Allocating Variability

Based on the information provided in Examples A.1 through A.4, Tables 16A-E present the allocation of expected losses and expected residual returns of Company BJ among all of its variable interest holders using the proportionate variability methodology.

To perform the allocation presented in Tables 16A-E, it is first necessary to determine the variability in cash flows to be received or paid by the managing member (decision maker), aircraft and hangar lenders, and guarantor.

Table 13 presents expected cash flows associated with fees paid to the managing member (decision maker) during the five-year operating term of Company BJ. For ease of illustration, cash flows are assumed to occur in equal amounts each year during the five-year period under each estimated cash flow scenario. In a typical situation the cash flows would vary from one year to the next under all scenarios.

<table>
<thead>
<tr>
<th>A (^1)</th>
<th>B (^2)</th>
<th>C</th>
<th>D = B × C</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1,173</td>
<td>$5,220</td>
<td>15%</td>
<td>$ 783</td>
</tr>
<tr>
<td>1,457</td>
<td>6,488</td>
<td>20%</td>
<td>1,298</td>
</tr>
<tr>
<td>1,672</td>
<td>7,445</td>
<td>30%</td>
<td>2,233</td>
</tr>
<tr>
<td>1,844</td>
<td>8,211</td>
<td>25%</td>
<td>2,053</td>
</tr>
<tr>
<td>2,179</td>
<td>9,700</td>
<td>10%</td>
<td>970</td>
</tr>
<tr>
<td>100%</td>
<td></td>
<td></td>
<td>$7,337</td>
</tr>
</tbody>
</table>

\(^1\) Fees paid to the managing member are 43% of cash basis net income excluding hangar operations and before payment of the managing member’s fees and guarantee fees. Example A.3 Table 2 column A, presents cash basis net income excluding hangar operations and fees paid to the managing member, annual interest payments on $64 million ($3.52 million per year), and guarantee fees ($456,000 per year). Accordingly, managing member fees are calculated by subtracting $3.52 million from each of the amounts in Example A.3 Table 2 column A, and multiplying each sum by 43% (e.g., [(6,247 - 3,520) × 43% = $1,173]).

\(^2\) Present value is determined based on a five-year annuity of the amount in column A discounted at a risk-free rate of 4%.
Table 14 presents Aircraft Guarantor’s calculation of its risk under the guarantee (i.e., the expected cash flows associated with its obligations under the guarantee contract). Table 14A presents expected cash flows associated with fees paid to the guarantor during the five-year operating term of Company BJ and is for informational purposes only.

For ease of illustration, the guarantee obligation and the guarantee asset are assumed to be equal. Because the guarantor typically would demand a profit on the guarantee contract, in an actual arrangement the expected cash flows under the guarantee obligation would probably be less than the expected cash flows from the guarantee fee. The risk calculated by the guarantor, given sufficient information, should be aligned with Company BJ’s expected cash flows from disposition of the aircraft at the end of the five-year operating term of the LLC as presented in Example A.3 Table 3.

<table>
<thead>
<tr>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D = B × C</th>
</tr>
</thead>
<tbody>
<tr>
<td>$(16,460)</td>
<td>$(13,529)</td>
<td>15%</td>
<td>$2,029</td>
</tr>
<tr>
<td>-</td>
<td>-</td>
<td>85%</td>
<td>-</td>
</tr>
<tr>
<td>100%</td>
<td>$2,029</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

1 Amount is calculated as the guaranteed value of $51.22 million less the cash flows from sale of the aircraft in Example A.3 Table 3 column A. Cash flows from Example A.3 Table 3 column A, that are greater than $51.22 million result in no payment to the LLC by the guarantor.

2 Present value is determined as the amount in column A received at the end of five years discounted at a risk-free rate of 4%.
Table 14A
Fees Paid to Guarantor
(Dollars in Thousands)

<table>
<thead>
<tr>
<th>A</th>
<th>B¹</th>
<th>C</th>
<th>D = B × C</th>
</tr>
</thead>
<tbody>
<tr>
<td>$456</td>
<td>$2,029</td>
<td>100%</td>
<td>$2,029</td>
</tr>
</tbody>
</table>

¹ Present value is determined based on a five-year annuity of the amount in column A discounted at a risk-free rate of 4%.

Table 15 presents the expected cash flows of Aircraft Lender. Note that the present value of the total contractual cash flows to be received by Aircraft Lender, when discounted at the risk free rate of 4%, exceeds the $64 million principal balance of the loan because the loan has an interest rate of 5.5% per annum. This reflects the lender’s expectation that it will not receive all of the cash flows due under the loan in all circumstances.

Table 15
Expected Cash Flows of Aircraft Lender
(Dollars in Thousands)

<table>
<thead>
<tr>
<th>Probability of Occurrence</th>
<th>Estimated Cash Flows</th>
<th>Present Value of Estimated Cash Flows</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Interest² Principal³</td>
<td>Interest⁴ Principal⁵</td>
<td></td>
</tr>
<tr>
<td>15%</td>
<td>$17,600 $51,220</td>
<td>$15,670 $42,099</td>
<td>$57,769</td>
</tr>
<tr>
<td>20%</td>
<td>17,600 52,185</td>
<td>15,670 42,892</td>
<td>58,562</td>
</tr>
<tr>
<td>30%</td>
<td>17,600 60,935</td>
<td>15,670 50,084</td>
<td>65,754</td>
</tr>
<tr>
<td>25%</td>
<td>17,600 64,000</td>
<td>15,670 52,604</td>
<td>68,274</td>
</tr>
<tr>
<td>10%</td>
<td>17,600 64,000</td>
<td>15,670 52,604</td>
<td>68,274</td>
</tr>
<tr>
<td>100%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expected Cash Flows¹</td>
<td></td>
<td></td>
<td>$64,000</td>
</tr>
</tbody>
</table>

¹ The methodology for computing expected cash flows based on probability-weighted estimated cash flows is illustrated in Example A.1 Table 1 based on a different stream of estimated cash flows.
The operating cash flows generated by the aircraft as indicated in Example A.3 Table 2 are sufficient to make the interest payments to Aircraft Lender of $3.52 million per year ($17.6 million = $3.52 million × 5 years) under all cash flow scenarios. The cash flows for repayment of the $64 million principal balance on the loan payable to Aircraft Lender will come from the disposition of the aircraft and the aircraft residual value guarantee. As indicated in Example A.3 Table 3, the cash flows from disposition of the aircraft are not sufficient in every cash flow scenario to repay the principal on the loan. In the first cash flow scenario, Aircraft Lender will receive the proceeds of the guarantee (shown in Table 14), increasing the cash flow that it otherwise would have received from the disposition of the aircraft by $16.46 million to $51.22 million ($34.76 million + $16.46 million = $51.22 million). In the second and third cash flow scenarios, the lender will receive only the cash flows from disposition of the aircraft of $52.185 million and $60.935 million, respectively. In the fourth and fifth cash flow scenarios, the disposition cash flows paid to the lender will be limited to the $64 million principal amount due.

Present value of interest cash flows is determined based on a five-year annuity of $3.52 million ($17.6 million = $3.52 million × 5 years) discounted at a risk-free rate of 4%. Present value of principal cash flows is determined based on the present value of estimated principal cash flows to be received at the end of five years discounted at a risk-free rate of 4%.

Table 15A presents the expected cash flows of Hangar Lender. Note that the present value of the total contractual cash flows to be received by Hangar Lender, when discounted at the risk free rate of 4%, equals the $4 million principal balance of the loan because the loan has an interest rate equal to the risk free rate. This reflects the lender’s expectation that it will receive all of the cash flows due under the loan in all circumstances.

<table>
<thead>
<tr>
<th>Probability of Occurrence</th>
<th>Estimated Cash Flows</th>
<th>Present Value of Estimated Cash Flows</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Interest²</td>
<td>Principal³</td>
</tr>
<tr>
<td>15%</td>
<td>$800</td>
<td>$4,000</td>
</tr>
<tr>
<td>20%</td>
<td>800</td>
<td>4,000</td>
</tr>
<tr>
<td>30%</td>
<td>800</td>
<td>4,000</td>
</tr>
<tr>
<td>25%</td>
<td>800</td>
<td>4,000</td>
</tr>
<tr>
<td>10%</td>
<td>800</td>
<td>4,000</td>
</tr>
<tr>
<td>100%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Expected Cash Flows¹

$4,000

¹ The methodology for computing expected cash flows based on probability-weighted estimated cash flows is illustrated in Example A.1 Table 1 based on a different stream of estimated cash flows.
The operating cash flows generated by the hangar as indicated in Example A.4 Table 6 are sufficient to make the interest payments to Hangar Lender of $160,000 per year ($800,000 = $160,000 × 5 years) under all cash flow scenarios.

The cash flows for repayment of the $4 million principal balance on the loan payable to Hangar Lender will come from the disposition of the hangar and the hangar residual value guarantee. As indicated in Example A.4 Table 7, the cash flows from disposition of the hangar are sufficient in every cash flow scenario to repay the principal on the loan.

Present value of interest cash flows is determined based on a five-year annuity of $160,000 ($800,000 = $160,000 × 5 years) discounted at a risk-free rate of 4%.

Present value of principal cash flows is determined based on the present value of estimated principal cash flows to be received at the end of five years discounted at a risk-free rate of 4%.

Table 16 presents the combined cash flows of the entity from the operations and disposition of the aircraft and hangar.

<table>
<thead>
<tr>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>E</th>
<th>F</th>
</tr>
</thead>
<tbody>
<tr>
<td>$61,295</td>
<td>15%</td>
<td>$85,000</td>
<td>$(23,705)</td>
<td>$(3,556)</td>
<td></td>
</tr>
<tr>
<td>78,608</td>
<td>20%</td>
<td>85,000</td>
<td>6,392</td>
<td>1,278</td>
<td></td>
</tr>
<tr>
<td>88,071</td>
<td>30%</td>
<td>85,000</td>
<td>3,071</td>
<td></td>
<td>921</td>
</tr>
<tr>
<td>94,005</td>
<td>25%</td>
<td>85,000</td>
<td>9,005</td>
<td>2,251</td>
<td></td>
</tr>
<tr>
<td>101,622</td>
<td>10%</td>
<td>85,000</td>
<td>16,622</td>
<td>1,662</td>
<td></td>
</tr>
</tbody>
</table>

100% |  | 85,000 |  | 4,834 | 4,834 |

1 Represents the sum of the present value amounts in Example A.3 Tables 2 and 3, and Example A.4 Tables 6 and 10.
2 From Example A.3 Tables 2 and 3, and Example A.4 Tables 6 and 10.
3 The methodology for computing expected cash flows based on probability-weighted estimated cash flows is illustrated in Example A.1 Table 1 based on a different stream of estimated cash flows.
Table 16A presents each variable interest holder’s share of the expected cash flows of the entity presented in Table 16. This information is the basis for determining the variability of each variable interest holder.

Table 16A
Participation by Variable Interest Holders in Estimated Cash Flows of Entity (Dollars in Thousands)

| Probability of Occurrence | PV of Cash Flows of Individual Variable Interest Holders | Total PV of Estimated Cash Flows
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Aircraft Lender$^2$</td>
<td>Hangar Lender$^3$</td>
</tr>
<tr>
<td>15%</td>
<td>$57,769</td>
<td>$4,000</td>
</tr>
<tr>
<td>20%</td>
<td>58,562</td>
<td>4,000</td>
</tr>
<tr>
<td>30%</td>
<td>65,754</td>
<td>4,000</td>
</tr>
<tr>
<td>25%</td>
<td>68,274</td>
<td>4,000</td>
</tr>
<tr>
<td>10%</td>
<td>68,274</td>
<td>4,000</td>
</tr>
</tbody>
</table>

100%

Expected Cash Flows$^1$ $64,000 $4,000 $17,000 $ $ $85,000

---

1 The methodology for computing expected cash flows based on probability-weighted estimated cash flows is illustrated in Example A.1 Table 1 based on a different stream of estimated cash flows.
2 From Table 15.
3 From Table 15A.
4 The members receive all cash flows not paid to other variable interest holders. This includes the fees paid to the managing member as presented in Table 13. Thus, the amounts in this column represent the residual cash flows of the LLC necessary to reconcile to the total present value of estimated cash flows to be received by the LLC, which are presented in Table 16.
5 As indicated in Table 14A, the present value of the guarantor’s annual fee is $2.029 million. In addition, because the guarantee is triggered if the value of the aircraft is less than $51.22 million at disposition, there is a 15% chance that the guarantor would be required to pay $16.46 million (which has a present value of $13.529 million) as indicated in Table 14. The net amount of $13.529 million subtracted from $2.029 million is negative $11.5 million.
6 From Table 16.
Table 16B presents the distribution of cash flows of members between the managing member and the passive member.

<table>
<thead>
<tr>
<th>Probability of Occurrence</th>
<th>Fees to Managing Member</th>
<th>Other Cash Flows</th>
<th>Total PV of Estimated Cash Flows</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Managing Member</td>
<td>Passive Member</td>
</tr>
<tr>
<td>15%</td>
<td>$5,220</td>
<td>$116</td>
<td>$5,690</td>
</tr>
<tr>
<td>20%</td>
<td>6,488</td>
<td>151</td>
<td>7,378</td>
</tr>
<tr>
<td>30%</td>
<td>7,445</td>
<td>177</td>
<td>8,666</td>
</tr>
<tr>
<td>25%</td>
<td>8,211</td>
<td>230</td>
<td>11,261</td>
</tr>
<tr>
<td>10%</td>
<td>9,700</td>
<td>352</td>
<td>17,267</td>
</tr>
<tr>
<td>100%</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Expected Cash Flows: $7,337, $193, $9,470, $17,000

1 The methodology for computing expected cash flows based on probability-weighted estimated cash flows is illustrated in Example A.1 Table 1 based on a different stream of estimated cash flows.
2 From Table 13.
3 Represents cash flows to members from aircraft and hangar operations (net of fees paid to the managing member) and the changes in fair value of the aircraft. Those cash flows are shared by members in proportion to their carried ownership percentages of 2% and 98%, respectively.
4 From Table 16A.
Table 16C presents the calculation of negative variability for each class of variable interest holder based on the information presented in Tables 16A and 16B.

<table>
<thead>
<tr>
<th>Probability of Occurrence</th>
<th>Aircraft Lender</th>
<th>Hangar Lender</th>
<th>Managing Member</th>
<th>Passive Member</th>
<th>Aircraft Guarantor</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>15%</td>
<td>$ (935)</td>
<td>$ -</td>
<td>$(329)</td>
<td>$ (567)</td>
<td>$ (1,725)</td>
<td>$ (3,556)</td>
</tr>
<tr>
<td>20%</td>
<td>(1,087)</td>
<td>-</td>
<td>(178)</td>
<td>(419)</td>
<td>-</td>
<td>(1,684)</td>
</tr>
<tr>
<td>30%</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>(241)</td>
<td>-</td>
<td>(241)</td>
</tr>
<tr>
<td>25%</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>10%</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>100%</td>
<td>$(2,022)</td>
<td>$ -</td>
<td>$(507)</td>
<td>$(1,227)</td>
<td>$(1,725)</td>
<td>$(5,481)</td>
</tr>
</tbody>
</table>

Proportionate Variability: 36.9%, 0.0%, 9.2%, 22.4%, 31.5%, 100.0%

1 The methodology for computing expected losses using probability-weighted estimated cash flows is illustrated in Example A.3 Table 2 based on a different stream of estimated cash flows.
Table 16D is presented for informational purposes only. It is not necessary to calculate both the negative and positive variability of individual variable interest holders because the proportionate variability can be derived from calculating one or the other. Negative variability will always be equal (and opposite) to positive variability. Table 16D presents the calculation of positive variability for each individual variable interest holder.

<table>
<thead>
<tr>
<th>Probability of Occurrence</th>
<th>Aircraft Lender</th>
<th>Hangar Lender</th>
<th>Managing Member</th>
<th>Passive Member</th>
<th>Aircraft Guarantor</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>15%</td>
<td>$ -</td>
<td>$ -</td>
<td>$ -</td>
<td>$ -</td>
<td>$ -</td>
<td>$ -</td>
</tr>
<tr>
<td>20%</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>406</td>
<td>406</td>
</tr>
<tr>
<td>30%</td>
<td>526</td>
<td>-</td>
<td>27</td>
<td>-</td>
<td>609</td>
<td>1,162</td>
</tr>
<tr>
<td>25%</td>
<td>1,068</td>
<td>-</td>
<td>228</td>
<td>448</td>
<td>507</td>
<td>2,251</td>
</tr>
<tr>
<td>10%</td>
<td>428</td>
<td>-</td>
<td>252</td>
<td>779</td>
<td>203</td>
<td>1,662</td>
</tr>
<tr>
<td>100%</td>
<td>$2,022</td>
<td>$ -</td>
<td>$507</td>
<td>$1,227</td>
<td>$1,725</td>
<td>$5,481</td>
</tr>
</tbody>
</table>

Proportionate Variability

<table>
<thead>
<tr>
<th>Aircraft Lender</th>
<th>Hangar Lender</th>
<th>Managing Member</th>
<th>Passive Member</th>
<th>Aircraft Guarantor</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>36.9%</td>
<td>0.0%</td>
<td>9.2%</td>
<td>22.4%</td>
<td>31.5%</td>
<td>100.0%</td>
</tr>
</tbody>
</table>

---
Table 16E presents the allocation of entity-level negative and positive variability (from Table 16) to each of the variable interest holders based on their proportionate variability as calculated in Tables 16C and 16D.

<table>
<thead>
<tr>
<th>Proportionate Variability(^1)</th>
<th>Aircraft Lender</th>
<th>Hangar Lender</th>
<th>Managing Member</th>
<th>Passive Member</th>
<th>Aircraft Guarantor</th>
<th>Total(^2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allocated Expected Losses</td>
<td>$(1,784)</td>
<td>$ -</td>
<td>$(445)</td>
<td>$(1,083)</td>
<td>$(1,522)</td>
<td>$(4,834)</td>
</tr>
<tr>
<td>Allocated Expected Residual</td>
<td>$ 1,784</td>
<td>$ -</td>
<td>$ 445</td>
<td>$ 1,083</td>
<td>$ 1,522</td>
<td>$ 4,834</td>
</tr>
</tbody>
</table>

\(^1\) From Tables 16C and 16D.
\(^2\) From Table 16.

**Question A.9: Consideration of Variable Interest Holders’ Credit Risk in Allocating an Entity’s Expected Losses**

If a variable interest holder could be required to absorb risks of an entity by providing future resources to the entity or to another variable interest holder in the entity (e.g., because the variable interest holder is a guarantor), should the possibility that the variable interest holder will not provide those resources under the agreement that it has with the entity or other variable interest holders affect the determination of the entity’s expected losses and/or the allocation of its expected losses to its variable interest holders?

**Interpretive Response:** Because a VIE’s expected losses and expected residual returns are determined based on its design, we generally do not believe they are affected by whether its variable interest holders will perform as agreed in absorbing those risks and rewards unless the variable interests are
non-substantive. As a result, we generally do not believe a VIE’s expected losses and expected residual returns should reflect nonperformance risk of its variable interest holders. In addition, when a variable interest holder’s interest requires it to potentially provide future resources to the entity or to another variable interest holder, we do not believe it is appropriate for the variable interest holder to reduce its share of the entity’s expected losses and expected residual returns to reflect the risk of its own nonperformance. However, when a variable interest holder’s interest requires it to potentially provide future resources to the entity or to another variable interest holder, we believe the allocation of the entity’s expected losses and expected residual returns to its other variable interest holders should reflect the nonperformance risk of the variable interest holder that may be required to provide future resources to the entity or its other variable interest holders. That is, the probability-weighted likelihood of nonperformance by the variable interest holder that may be required to provide future resources to the entity or its other variable interest holders multiplied by the amount of the entity’s variability allocable to that variable interest holder should be allocated to the entity’s other variable interest holders. As a result, the allocation of the entity’s variability to its variable interest holders in such circumstances generally will exceed the entity’s total variability. That excess will not be eliminated as illustrated in Example A.5.
Appendix B – Glossary of VIE Terms In ASC Subtopic 810-10

B.000 The following terms used in the variable interest entities subsections of ASC Subtopic 810-10, Consolidation - Overall, are included in ASC Section 810-10-20.

**Excerpts from ASC Subsection 810-10-20**

**Acquiree**
The *business* or *businesses* that the *acquirer* obtains control of in a *business combination*. This term also includes a nonprofit activity or business that a not-for-profit acquirer obtains control of in an *acquisition by a not-for-profit entity*.

**Acquirer**
The entity that obtains control of the *acquiree*. However, in a *business combination* in which a *variable interest entity* (VIE) is acquired, the primary beneficiary of that entity always is the acquirer.

**Acquisition by a Not-for-Profit Entity**
A transaction or other event in which a not-for-profit acquirer obtains control of one or more nonprofit activities or businesses and initially recognizes their assets and liabilities in the acquirer’s financial statements. When applicable guidance in Topic 805 is applied by a *not-for-profit entity*, the term *business combination* has the same meaning as this term has for a not-for-profit entity. Likewise, a reference to business combinations in guidance that links to Topic 805 has the same meaning as a reference to acquisitions by not-for-profit entities.

**Acquisition, Development, and Construction Arrangements**
Acquisition, development, or construction arrangements, in which a lender, usually a financial institution, participates in expected residual profit from the sale or refinancing of property.

**Business**
An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants. Additional guidance on what a business consists of is presented in paragraphs 805-10-55-4 through 55-9.

**Business Combination**
A transaction or other event in which an *acquirer* obtains control of one or more businesses. Transactions sometimes referred to as true mergers or
mergers of equals also are business combinations. See also Acquisition by a Not-for-Profit Entity.

Collateralized Financing Entity

A variable interest entity that holds financial assets, issues beneficial interests in those financial assets, and has no more than nominal equity. The beneficial interests have contractual recourse only to the related assets of the collateralized financing entity and are classified as financial liabilities. A collateralized financing entity may hold nonfinancial assets temporarily as a result of default by the debtor on the underlying debt instruments held as assets by the collateralized financing entity or in an effort to restructure the debt instruments held as assets by the collateralized financing entity. A collateralized financing entity also may hold other financial assets and financial liabilities that are incidental to the operations of the collateralized financing entity and have carrying values that approximate fair value (for example, cash, broker receivables, or broker payables).

Combined Financial Statements

The financial statements of a combined group of commonly controlled entities or commonly managed entities presented as those of a single economic entity. The combined group does not include the parent.

Consolidated Financial Statements

The financial statements of a consolidated group of entities that include a parent and all its subsidiaries presented as those of a single economic entity.

Consolidated Group

A parent and all its subsidiaries.

Decision Maker

An entity or entities with the power to direct the activities of another legal entity that most significantly impact the legal entity’s economic performance according to the provisions of the Variable Interest Entities Subsections of Subtopic 810-10.

Decision-Making Authority

The power to direct the activities of a legal entity that most significantly impact the entity’s economic performance according to the provisions of the Variable Interest Entities Subsections of Subtopic 810-10.

Equity Interests

Used broadly to mean ownership interests of investor-owned entities; owner, member, or participant interests of mutual entities; and owner or member interests in the net assets of not-for-profit entities.

Expected Losses

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

**Expected Losses and Expected Residual Returns**

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

**Expected Residual Returns**

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

**Expected Variability**

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

**Kick-Out Rights (VIE Definition)**

The ability to remove the entity with the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance or to dissolve (liquidate) the VIE without cause.

**Kick-Out Rights (Voting Interest Entity Definition)**

The rights underlying the limited partner’s or partners’ ability to dissolve (liquidate) the limited partnership or otherwise remove the general partners without cause.

**Legal Entity**

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

**Limited Partnership**

An association in which one or more general partners have unlimited liability and one or more partners have limited liability. A limited partnership is usually managed by the general partner or partners, subject to limitations, if any, imposed by the partnership agreement.
Noncontrolling Interest
The portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent. A noncontrolling interest is sometimes called a minority interest.

Nonprofit Activity
An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing benefits, other than goods or services at a profit or profit equivalent, as a fulfillment of an entity’s purpose or mission (for example, goods or services to beneficiaries, customers, or members). As with a not-for-profit entity, a nonprofit activity possesses characteristics that distinguish it from a business or a for-profit business entity.

Nonpublic Entity
Any entity other than one with any of the following characteristics:

(a) Whose debt or equity securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally

(b) That is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets)

(c) That makes a filing with a regulatory agency in preparation for the sale of any class of debt or equity securities in a public market

(d) That is controlled by an entity covered by a, b., or c.

Conduit debt securities refers to certain limited-obligation revenue bonds, certificates of participation, or similar debt instruments issued by a state or local governmental entity for the express purpose of providing financing for a specific third party (the conduit bond obligor) that is not a part of the state or local government’s financial reporting entity. Although conduit debt securities bear the name of the governmental entity that issues them, the governmental entity often has no obligation for such debt beyond the resources provided by a lease or loan agreement with the third party on whose behalf the securities are issued. Further, the conduit bond obligor is responsible for any future financial reporting requirements.

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

(a) Contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return

(b) Operating purposes other than to provide goods or services at a profit
(c) Absence of ownership interests like those of business entities.

Entities that clearly fall outside this definition include the following:

(a) All investor-owned entities

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

Ordinary Course of Business

Decisions about matters of a type consistent with those normally expected to be addressed in directing and carrying out current business activities, regardless of whether the events or transactions that would necessitate such decisions are expected to occur in the near term. However, it must be at least reasonably possible that those events or transactions that would necessitate such decisions will occur. The ordinary course of business does not include self-dealing transactions.

Owners

Used broadly to include holders of ownership interests (equity interests) of investor-owned entities, mutual entities, or not-for-profit entities. Owners include shareholders, partners, proprietors, or members or participants of mutual entities. Owners also include owner and member interests in the net assets of not-for-profit entities.

Parent

An entity that has a controlling financial interest in one or more subsidiaries. (Also, an entity that is the primary beneficiary of a variable interest entity.)

Participating Rights (VIE Definition)

The ability to block or participate in the actions through which an entity exercises the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance. Participating rights do not require the holders of such rights to have the ability to initiate actions.

Participating Rights (Voting Interest Entity Definition)

Participating rights allow the limited partners or noncontrolling shareholders to block or participate in certain significant financial and operating decisions of the limited partnership or corporation that are made in the ordinary course of business. Participating rights do not require the holders of such rights to have the ability to initiate actions.

Primary Beneficiary

An entity that consolidates a variable interest entity (VIE). See paragraphs 810-10-25-38 through 25-38G for guidance on determining the primary beneficiary.
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.

Protective Rights (VIE Definition)
Rights designed to protect the interests of the party holding those rights without giving that party a controlling financial interest in the entity to which they relate. For example, they include any of the following:

(a) Approval or veto rights granted to other parties that do not affect the activities that most significantly impact the entity’s economic performance. Protective rights often apply to fundamental changes in the activities of an entity or apply only in exceptional circumstances. Examples include both of the following:

(1) A lender might have rights that protect the lender from the risk that the entity will change its activities to the detriment of the lender, such as selling important assets or undertaking activities that change the credit risk of the entity.

(2) Other interests might have the right to approve a capital expenditure greater than a particular amount or the right to approve the issuance of equity or debt instruments.

(b) The ability to remove the reporting entity that has a controlling financial interest in the entity in circumstances such as bankruptcy or on breach of contract by that reporting entity.

(c) Limitations on the operating activities of an entity. For example, a franchise agreement for which the entity is the franchisee might restrict certain activities of the entity but may not give the franchisor a controlling financial interest in the franchisee. Such rights may only protect the brand of the franchisor.

Protective Rights (Voting Interest Entity Definition)
Rights that are only protective in nature and that do not allow the limited partners or noncontrolling shareholders to participate in significant financial and operating decisions of the limited partnership or corporation that are made in the ordinary course of business.

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 footnotes) 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.

Publicly Traded Entity (or Public Entity)
Any entity that does not meet the definition of a nonpublic entity.

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.

**Subordinated Financial Support**

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

**Subsidiary**

An entity, including an unincorporated entity such as a partnership or trust, in which another entity, known as its parent, holds a controlling financial interest. (Also, a variable interest entity that is consolidated by a primary beneficiary.)

**Underlying**

A specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable (including the occurrence or nonoccurrence of a specified event such as a scheduled payment under a contract). An underlying may be a price or rate of an asset or liability but is not the asset or liability itself. An underlying is a variable that, along with either a notional amount or a payment provision, determines the settlement of a derivative instrument.

**Variable Interest Entity**

A legal entity subject to consolidation according to the provisions of the Variable Interest Entities Subsections of Subtopic 810-10.

**Variable Interests**

The investments or other interests that will absorb portions of a variable interest entity’s (VIE’s) expected losses or receive portions of the entity’s expected residual returns are called variable interests. Variable interests in a VIE are contractual, ownership, or other pecuniary interests in a VIE that change with changes in the fair value of the VIE’s net assets exclusive of variable interests. Equity interests with or without voting rights are considered variable interests if the legal entity is a VIE and to the extent that the investment is at risk as described in paragraph 810-10-15-14. Paragraph 810-10-25-55 explains how to determine whether a variable interest in specified assets of a legal entity is a variable interest in the entity. Paragraphs 810-10-55-16 through 55-41 describe various types of variable interests and explain in general how they may affect the determination of the primary beneficiary of a VIE.
**With Cause**

With cause generally restricts the limited partners’ ability to dissolve (liquidate) the limited partnership or remove the general partners in situations that include, but that are not limited to, fraud, illegal acts, gross negligence, and bankruptcy of the general partners.

**Without Cause**

Without cause means that no reason need be given for the dissolution (liquidation) of the limited partnership or removal of the general partners.
## Appendix C – Summary of Changes to This Publication

**C.000** This publication has been updated to reflect the following developments since the January 2016 version:

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