Dear Clients and Friends:

The requirement to include or consolidate the financial statements of entities over which a reporting entity has a controlling financial interest is a concept in accounting that has been in place for many years. The application of this guidance continues to be challenging, particularly for certain types of structured entities or entities that have limited purposes. To address these challenges, the standard setters created what is essentially a different accounting model to be applied when determining if a reporting entity is required to consolidate these types of entities (known as variable interest entities). This accounting model has been modified a number of times over the years and preparers, auditors, and regulators continue to develop interpretations for new fact patterns that arise. In addition, the standard setters are deliberating additional amendments to the guidance.

PwC is pleased to offer this comprehensive guide on the consolidation model for variable interest entities. It is intended to assist you in interpreting the existing literature in this complex area of accounting by bringing together all of the key guidance into one publication. It provides several examples to help navigate the guidance, and offers our perspective throughout, based on both analysis of the guidance and our experience in applying it.

This guide is intended to clarify the fundamental requirements involved in the accounting and disclosure for variable interest entities and to highlight key points that should be considered before and after transactions are undertaken. It is not a substitute for a thorough analysis of the facts and circumstances of a particular transaction, nor should it be read in place of the relevant accounting literature. We hope you will find in these pages the information and insights needed to work with greater confidence and certainty when applying the consolidation model for variable interest entities.

PricewaterhouseCoopers LLP
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Executive summary

Recognizing that the application of voting control based consolidation accounting models to certain types of entities and structures did not result in the most meaningful financial presentation, the FASB created an accounting model to specifically address variable interest entities or “VIEs.” Over time, the FASB has made significant changes to the VIE consolidation model and is in deliberations following the issuance of an exposure draft to further amend the model.

This fifth edition of our monograph provides the latest additional discussion and examples on a number of emerging practice issues involving the accounting for variable interest entities to consider in applying the model. The purpose of this guide is to clarify a complex area of accounting by bringing together, in one publication, all of the relevant PwC guidance on accounting for variable interest entities; to provide an overall framework for the application of the VIE model; to highlight key questions and answers; and to offer our perspectives, based on our analysis of the guidance and experience in applying it.

The consolidation model for Variable Interest Entities in a nutshell

Under GAAP, a reporting entity must consolidate any entity in which it has a controlling financial interest. Under the voting interest model, generally the investor that has voting control (usually more than 50 percent of an entity’s voting interests) consolidates the entity. Under the VIE model, the party that has the power to direct the entity’s most significant economic activities and the ability to participate in the entity’s economics consolidates the entity. This party could be an equity investor, some other capital provider, or a party with contractual arrangements.

To determine which accounting model applies, and which—if any—party must consolidate a particular entity, a reporting entity must first determine whether the entity is a voting interest entity or a variable interest entity. An entity is considered a VIE if it possesses one of the following characteristics:

Characteristic 1 — The entity is thinly capitalized

Traditionally, it has been presumed that the equity provided by residual equity holders is sufficient to support the entity’s operations. If the equity is not sufficient, voting power attributed to the entity’s equity holders (i.e., under the voting interest model) is not the only factor that should be considered in a determination of who should consolidate the entity.

Characteristic 2 — Residual equity holders do not control the entity

The voting interest model should not be applied if the residual equity holders cannot control the entity’s destiny. This runs counter to conventional economic thinking, which suggests that the holder of an entity’s residual equity should be in a position to control its destiny.
Characteristics 3 & 4 — Equity holders are shielded from economic losses or do not participate fully in an entity’s residual economics

Conventional economic thinking suggests that residual equity holders should not only enjoy the rewards of owning an entity, but also be exposed to the risks of ownership. Such thinking does not extend to contractual arrangements that shield equity holders from losses associated with the entity’s predominant risks or that either cap the return on equity or allow the returns to be shared with other parties. In the case of such arrangements, a reporting entity should not use the voting interest model to decide which party consolidates the entity.

Characteristic 5 — The entity was established with non-substantive voting interests

The guidance includes an anti-abuse clause that prevents the sponsor of an entity from structuring or organizing it in a way that allows the sponsor to avoid consolidation under the voting interest model. The anti-abuse clause requires a two-part test. First, a reporting entity must determine if the distribution of economic benefits generated by an entity is proportionate to equity ownership and voting rights. If they are not proportionate, the reporting entity must determine whether substantially all of the entity’s activities either involve or are conducted on behalf of a party that has voting rights disproportionately low relative to its economic interest. When both conditions exist (i.e., the distribution of economic benefits is disproportionate to equity ownership/voting rights and substantially all of the entity’s activities either involve or are conducted on behalf of a party with disproportionately low voting rights), the entity is deemed a VIE and is subject to the risk and rewards model.

Determining the “primary beneficiary”

The reporting entity that consolidates a VIE is the primary beneficiary of that entity. A party consolidates a VIE when that party has a variable interest (or combination of variable interests) that provides the party with a controlling financial interest. A party is deemed to have a controlling financial interest if it meets both of the following criteria:

- Power criterion—Power to direct activities of the VIE that most significantly impact the VIE’s economic performance.
- Losses/benefits criterion—Obligation to absorb losses from or right to receive benefits of the VIE that could potentially be significant to the VIE.

Variable Interest Entity consolidation analyses are not static events

The characterization of an entity as either a voting interest entity or a VIE can change during the entity’s life. This may result from changes in the entity’s capital structure and/or in its activities or assets. These changes are known as “reconsideration events.” The reconsideration of a VIE’s primary beneficiary, however, is not limited to certain reconsideration events. Instead, a VIE’s primary beneficiary is an ongoing assessment.
**Establishing sound policies and procedures**

Reporting entities must gain access to the terms of each entity's key contractual arrangements, as well as be sure to understand the implications of those arrangements. Such contractual arrangements include those that establish governance practices and those that absorb economic gains and losses. Under the voting interest model, some of these contracts—including derivative contracts, leases, royalty contracts, and licenses—were generally ignored in the consolidation analysis. Since under the VIE model a reporting entity might have to consolidate entities over which it does not have complete control over all activities, the reporting entity must ensure that such contracts are considered during the information-gathering process.

The guidance in the VIE model will affect financial statements, as well as many other things, including companies’ financial ratios, debt covenants, and credit ratings.

**On the horizon — The FASB / IASB joint consolidation project**

In November 2011, the FASB issued an exposure draft proposing changes to the consolidation guidance for VIEs and partnerships that are not VIEs.

The proposal provided that a reporting entity that has a variable interest in a VIE and decision-making authority would need to assess whether it uses its decision-making authority to act in a principal or an agent capacity. A decision maker determined to be an agent would not consolidate the entity. The principal versus agent analysis would also be instrumental in determining if the entity is a VIE.

With respect to partnerships, the presumption that a general partner controls a partnership that is a voting interest entity could be overcome by applying the same principal versus agent assessment and determining that the general partner is using its power in an agent capacity.

The proposal would rescind ASU 2010-10, Consolidation (Topic 810), Amendments for Certain Investment Funds, which deferred application of the most recently developed VIE model in ASC 810 for certain types of investment entities. The most recently developed VIE model focuses on power and potentially significant economic interests. Those entities subject to the deferral are currently continuing to apply the prior VIE model which was based on absorbing a majority of risks and rewards. The proposal could also impact the consolidation conclusion for other entities and partnerships that were not subject to the deferral. The effective date has not been determined.

The comment letter period ended in February 2012. The FASB is in the process of re-deliberating many of the key aspects of the proposal. Consequently, significant changes may be made before the standard is finalized, which is currently targeted for the second half of 2013.

The IASB issued IFRS 10, Consolidated Financial Statements, in May 2011, introducing new guidance on when investors will have to consolidate investees. The key principle in IFRS 10 is that control exists, and consolidation is required, only if the investor possesses power over the investee, has exposure to variable returns from its
involvement with the investee, and has the ability to use its power over the investee to affect its returns. Although this definition of control is broadly consistent with the control definition for VIEs that was introduced by the FASB’s VIE model in ASC 810, it applies to all entities, including entities that would be considered voting interest entities under U.S. GAAP. In evaluating control, IFRS 10 also includes the principal versus agent analysis that is similar to the one proposed by the FASB in November 2011. Consequently, if the FASB changes are adopted as proposed, IFRS and U.S. GAAP consolidation guidance would be broadly aligned for VIEs although some differences may exist.

**Shortlist of potential VIEs: Transactions, relationships and structures**

**Leasing/real estate**

- Sale-leasebacks of real estate or equipment.
- Built-to-suit real estate or equipment subject to an operating lease (e.g., office buildings, manufacturing plants, airplanes).
- Synthetic leases (lease structures that are treated as operating leases for accounting purposes, even though for tax purposes the lessee is considered the owner).
- Certain partnerships in real estate investments.

**Financial assets**

- Transactions involving the sale/transfer of financial assets such as receivables (e.g., factoring arrangements or securitizations) to SPEs.
- Transactions involving a commercial paper conduit, such as sponsoring a conduit to purchase and securitize assets from third parties.
- Securitization transactions involving commercial debt obligations, collateralized-bond obligations, and commercial-loan obligations.
- Vehicles used to hedge off-balance sheet positions.

**Start-ups, research and development**

- Funding arrangements for research and development.
- Newly formed entities that are designed to manage or fund the start-up of a new product or business.
- Entities sponsored by venture capital reporting entities.
- Reporting entities in the developmental stage.
**Vendor financing**

- Structures designed to help customers finance the purchase of products and services (i.e., vendor financing), often in collaboration with a financial institution.

**Insurance**

- Insurance associations (reciprocals).
- Reinsurance securitizations.

**Transactions involving management, officers and employees**

- The transfer or sale of assets to an entity owned by a single employee or by members of an entity’s management.
- Management of an unconsolidated asset or business by a reporting entity or its officers.
- Funding of an entity’s independent equity by another reporting entity’s managing members.

**Obligations associated with other entities**

- Certain captive arrangements operated on behalf of an investor.
- A reporting entity’s guarantee of (i) an unconsolidated entity’s performance or debt or (ii) the value of an asset held by the unconsolidated entity (including explicit and implicit guarantees).
- A reporting entity’s contingent liability should an unconsolidated entity default.
- A transaction with an embedded “put” option that enables the entity or an outside party to sell the assets and/or operations back to a reporting entity.
- A transaction with an embedded call option that allows a reporting entity to repurchase the assets and/or operations that were previously sold to another entity.
- A reporting entity’s enhancement of another entity’s credit (e.g., via escrow funds, collateral agreements, discounts on transferred assets, take-or-pay arrangements).
- An agreement requiring a reporting entity to make a payment if its credit rating is downgraded.

**Rights to assets**

- Rights to use an “under construction” asset not recorded in the reporting entity’s balance sheet (the debt used to fund the construction being recourse only to that specific asset).
Executive summary

- Leasing assets from an entity that financed these assets with debt that is recourse to the individual asset rather than to all of the lessor entity’s assets.

- The transfer of financial assets to an entity subject to debt that is recourse only to those financial assets rather than to all of the entity’s assets.

- Variable lease payments, variable license-fee payments, or other variable payments for the right to use an asset (e.g., the payments change with fluctuations in market interest rates).

- Ownership of an asset that a reporting entity holds for tax purposes but does not record on its balance sheet.

Other

- Sale of assets or operations where the seller retains some governance rights and/or an economic interest.

- The purchase of businesses or assets by a third party or a newly formed entity on behalf of another company (i.e., an off-balance-sheet acquisition vehicle).

- Investments made through intermediaries in entities that generate losses from a financial-reporting perspective.

- Tolling arrangements with project finance companies.

- Transactions in which a reporting entity’s primary counterparties are financial institutions (e.g., banks, private equity funds, insurance companies).

- Arrangements with an entity whose capital structure (often the equity) is partially owned by (or provided by) a charitable trust.

- An unconsolidated entity whose name is included in the reporting entity’s name.

- When a reporting entity provides administrative or other services on behalf of an unconsolidated entity or services its assets.

- When an unconsolidated entity provides financing or other services exclusively to a reporting entity, its vendors or customers.
Chapter 1: Definition of key terms
Definition of key terms

**Executive takeaway**

- There are several terms and concepts that are important to understand before attempting to apply Variable Interest Entities Subsections of FASB Accounting Standards Codification 810, Consolidation (the VIE model). Many of these concepts necessitate a different way of thinking and make the guidance a challenge to understand and apply.

- Expected losses and expected residual returns are not GAAP losses and returns.

- The primary beneficiary is the party required to consolidate a variable interest entity.

- Shared power is when power to direct activities that are most significant to the entity’s economic success is shared among non-related variable interest holders and decisions with regard to these activities require the consent of each of the parties sharing power.

- The identification of related parties and “de facto agents” is critical in evaluating entities under the VIE model.
1.1 **Voting interest entity**

Although the term “voting interest entity” is not defined in the VIE model, it has emerged in the accounting practice as a term meaning an entity that is not a variable interest entity (VIE). In a voting interest entity, the equity investment is deemed sufficient to absorb the expected losses of the entity, and the equity investment has all of the characteristics of a controlling financial interest. As a result, voting rights are the key driver for determining which party, if any, should consolidate the entity. All entities that are not VIEs (and therefore meet the definition of voting interest entities) are subject to consolidation guidance in the other (not variable interest entity) subsections of ASC 810, *Consolidation* (ASC 810).

1.2 **Variable interest entity**

A VIE is an entity subject to the VIE model discussed in ASC 810. This model identifies the party, if one exists, that possesses a controlling financial interest in a VIE and is required to consolidate it. A VIE is defined as follows:

**Excerpt from ASC 810-10-20**

*Variable interest entity* refers to a legal entity subject to consolidation according to the provisions of the Variable Interest Subsections of Subtopic 810-10.

A VIE is an entity that by design possesses the following characteristics:

- The equity investment at risk is not sufficient for the entity to finance its activities without additional subordinated financial support; or

- As a group, the holders of equity investment at risk do not possess:
  1. The power, through voting rights or similar rights, to direct the activities that most significantly impact the entity’s economic performance; or
  2. The obligation to absorb expected losses or the right to receive the expected residual returns of the entity; or
  3. Symmetry between voting rights and economic interests and where substantially all of the entity’s activities either involve or are conducted on behalf of an investor with disproportionately fewer voting rights (e.g., structures with nonsubstantive voting rights).

A VIE is different from a voting interest entity because it is designed in a manner where voting rights held by equity holders are ineffective in determining which party has a controlling financial interest in the entity. The VIE model is based on the fundamental concept that the voting interest model may not identify the party with the controlling financial interest in a VIE, because control of an entity may be achieved through arrangements that do not involve voting equity.
1.3 **Primary beneficiary**

A primary beneficiary is defined as follows:

**Excerpt from ASC 810-10-20**

*Primary beneficiary* refers to an entity that consolidates a variable interest entity.

The primary beneficiary of a VIE is the variable interest holder (e.g., a contractual counterparty or capital provider) deemed to have the controlling financial interest(s) in the VIE and therefore must consolidate it. The primary beneficiary is not necessarily the party with the majority or even any of the voting interests in an entity. Rather, the primary beneficiary is the reporting entity (or member of a related party group—see VE 5.1 for more details) that has both of the following characteristics:

a. the power to direct the activities that most significantly impact the VIE’s economic performance; and

b. the obligation to absorb losses or the right to receive benefits that could potentially be significant to the VIE.

Note that a primary beneficiary need not be a legal entity. For example, an individual that holds a variable interest in an entity may be its primary beneficiary.

The most recent amendments to the VIE model introduced a new term—“shared power” in the evaluation of the primary beneficiary.

**Excerpt from ASC 810-10-25-38D**

...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 power is shared with other unrelated parties such that no one party has the power to direct activities that most significantly impact the VIE’s economic performance, then the reporting entity is not deemed to be the primary beneficiary.

VE 5 discusses in detail the analysis involving the identification of the primary beneficiary of a VIE.

1.4 **Variable interest**

A variable interest is an accounting term used in the VIE model to describe any contractual or sometimes implied relationship that a reporting entity has with a VIE that shares in the VIE’s risks and rewards. A variable interest could be in many forms, but is commonly an investment in, financing provided to, or monetary arrangement with a VIE. However, there are more unconventional relationships with a VIE that...
may be variable interests (e.g., certain service contracts). A variable interest is defined as follows:

**Excerpt from ASC 810-10-20**

*Variable interests* are 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. 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 entity’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 explains in general how they may affect the determination of the primary beneficiary of a VIE.

The identification of a variable interest represents one of the more challenging aspects of the VIE model. This is highlighted in ASC 810, as follows:

**Excerpt from ASC 810-10-55-19**

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

It is the changes in the cash flows generated by certain interests that drive the success or failure of the entity, thus “creating” the variability in the entity. Most forms of financing or capital (including guarantees and some derivative instruments) absorb variability of an entity. The return to the creditor or capital provider is dependent upon the success or failure of the interests described above (those that create the variability), thus these interests “absorb” the variability of the entity. Only those interests that absorb the variability of the entity’s cash flows are considered variable interests.

A simple example of a contractual relationship that absorbs an entity’s variability is an equity investment in the entity. The equity investment absorbs some or all of the changes in the fair value of the entity’s assets (its variability). If the entity generates poor operating cash flows (below expectations), the holder of that equity investment will receive a lower return on its investment—thus absorbing some of the negative variability in the entity. Although this example is relatively straightforward, distinguishing between economic interests that create or absorb variability can be challenging. This is especially true when evaluating entities with complex capital
structures, various service or management agreements, and/or derivative instruments.

Refer to VE 3 for a detailed discussion of variable interests.

### 1.5 Subordinated financial support

Subordinated financial support is defined as follows:

**Excerpt from ASC 810-10-20**

*Subordinated financial support* refers to variable interests that will absorb some or all of a variable interest entity’s (VIE’s) expected losses.

An equity investment in a VIE would be considered a form of subordinated financial support because it often provides the VIE with subordinate financing, thus absorbing at least some amount of the entity’s expected losses (or negative variability). Other forms of subordinated financial support would include loans to the entity; commitments to fund an entity’s operations; certain guarantees on an entity’s assets; as well as certain derivative instruments. Depending on the facts and circumstances, other economic interests in an entity may meet the definition of subordinated financial support (such as certain service/management contracts).

### 1.6 Expected losses and expected residual returns

While the earlier VIE model (prior to the amendments in Accounting Standards Update No. 2009-17, *Consolidations (Topic 810)—Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities* (ASU 2009-17)) used a risks and rewards model to determine the primary beneficiary of a VIE, the VIE model as amended by ASU 2009-17 focuses on the power and losses/benefits criteria to determine the primary beneficiary of a VIE. Therefore, the expected losses and expected residual returns concept is not as significant under the VIE model as amended by ASU 2009-17. However, there are still some provisions in the VIE model as amended by ASU 2009-17 that refer to the expected losses and expected residual returns concept. Therefore, it is helpful to understand these concepts and how they are interpreted.

Expected losses and expected residual returns as well as expected variability are defined as follows:

**Excerpt from ASC 810-10-20**

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

The definition of expected losses and expected residual returns is further defined as follows:

**Excerpt from ASC 810-10-20**

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

*Expected 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 losses are not the GAAP losses that are expected to be incurred by the entity; and expected residual returns are not the GAAP income that is expected to be earned by the entity. Rather, they are statistical measures of the variability (or risk) inherent in the fair value of a particular entity.

Many reporting entities have mistakenly assumed that entities that generate only net income (i.e., entities that do not expect to incur GAAP losses) would not have expected losses. That logic is flawed since expected losses do not reflect the anticipated amount of variability of net income or loss, but rather the negative variability in the fair value of an entity’s net assets. This point is clarified in the definition of expected losses as included in the excerpt above.

Generally speaking, the riskier the activities (or the assets) of the entity, the greater the expected losses and expected residual returns. All entities have expected losses and expected residual returns since there is at least some level of risk associated with their activities.

ASC 810-10-55-42 through 55-49 demonstrates the calculation of an entity’s expected losses and expected residual returns (included below), using the present-value methodology, as described in CON 7. The cash flow modeling approach used in CON 7 requires a determination of expected cash flows by considering multiple cash flow scenarios and the inherent uncertainty as to the timing and amount of those cash flows. Possible cash flow scenarios are to be identified, along with the relative probability of each scenario occurring. The probability-weighted cash flow estimates
are then discounted using an “appropriate” discount rate to arrive at their present values. Using this approach, the present value of the total expected cash flows associated with those assets should equal their fair value.

The determination of the appropriate discount rate requires judgment. Under the CON 7 model, the FASB indicated that the individual cash flows should be explicitly adjusted for the risk of uncertainty and discounted back using the risk-free rate. However many traditional valuation techniques do not involve adjustments to each cash flow scenario to account for the risk of uncertainty. Instead, many valuation experts utilize a weighted-average cost of capital because this discount rate considers the uncertainty in the entity’s cash flows. We believe that clients should consider consulting with designated PwC valuation specialists when faced with such decisions. These two methods are further described in ASC 820, *Fair Value Measurements and Disclosures* (ASC 820).

### 1.6.1 Simple illustration for calculating expected losses and expected residual returns

The example includes the following assumptions:

**Excerpt from ASC 810-10-55-42**

1. A single party holds all of the beneficial interests in the VIE, and the VIE has no liabilities
2. There is no decision maker because the VIE’s activities are completely predetermined
3. All cash flows are expected to occur in one year or not to occur at all
4. The appropriate discount rate (the interest rate on risk-free investments) is 5 percent
5. 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.

A set of six possible (or estimated) cash flow scenarios are illustrated. Each of these scenarios is probability weighted, the sum of which represents the entity’s “expected cash flows.” From the illustration below, the entity’s expected cash flows are $795,000 (the present value of those expected cash flows is $757,143).
Excerpt from ASC 810-10-55-44

(Amounts in thousands)

<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>
<tr>
<td>100.0%</td>
<td></td>
<td>$795,000</td>
<td>$757,143</td>
</tr>
</tbody>
</table>

For each scenario where the estimated cash flow is less than the expected cash flow of the entity, there is an expected loss. For example, from the illustration below, in the first scenario the estimated cash flows are $650,000 and the expected cash flows of the entity are $795,000, resulting in negative deviation in that scenario of $145,000. When probability-weighted and present-valued, the expected loss generated by the first scenario is $6,905. The sum of all of the scenarios in which the estimated cash flows are less than the expected cash flows equals the total expected losses of the entity ($26,667).

Excerpt from ASC 810-10-55-46

<table>
<thead>
<tr>
<th>Estimated cash flows</th>
<th>Expected cash flows</th>
<th>Difference estimated (losses) residual returns</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>100.0%</td>
<td></td>
<td>$(28,000)</td>
<td></td>
<td>$(26,667)</td>
<td></td>
</tr>
</tbody>
</table>

The same calculation is performed for the expected residual returns, only using the scenarios where the estimated cash flows are greater than the expected cash flows. For example, from the illustration below, the entity’s expected residual returns are
calculated as $26,667. It is no coincidence that these two amounts are equivalent, since an entity’s expected losses will always equal its expected residual returns as a result of this calculation.

<table>
<thead>
<tr>
<th>Estimated cash flows</th>
<th>Expected cash flows</th>
<th>Difference estimated (losses) residual returns</th>
<th>Probability</th>
<th>Expected residual return based on expected cash flows</th>
<th>Expected residual return 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></td>
<td></td>
</tr>
<tr>
<td>700,000</td>
<td>795,000</td>
<td>(95,000)</td>
<td>10.0</td>
<td>$1,250</td>
<td>$1,191</td>
</tr>
<tr>
<td>750,000</td>
<td>795,000</td>
<td>(45,000)</td>
<td>25.0</td>
<td>11,000</td>
<td>10,476</td>
</tr>
<tr>
<td>800,000</td>
<td>795,000</td>
<td>5,000</td>
<td>25.0</td>
<td>15,750</td>
<td>15,000</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></td>
<td></td>
<td></td>
<td>100.0%</td>
<td>$28,000</td>
<td>$26,667</td>
</tr>
</tbody>
</table>

While the CON 7 methodology is outlined as the model for calculating an entity’s expected losses and expected residual returns, it is not the only acceptable method. Since expected losses and expected residual returns are calculated based on how widely potential future outcomes differ from the expected outcome, expected losses can be calculated using the value of a put option written on the value of an asset (or group of assets). The volatility related to the expected outcome can usually be calculated by reference to readily available capital-market information relating to asset values and may be preferable to subjectively determined distributions of future value under the CON 7 methodology.

There is little guidance on how a reporting entity would derive the cash flow estimates necessary to perform these calculations. It is clear that the first step for a reporting entity is to identify the variable interests in the entity. Variable interests in an entity are those assets, liabilities, or equity that absorb an entity’s variability. For purposes of the expected loss calculation, net assets of the entity are those assets and liabilities that create variability in the entity and thus are not variable interests. It is the riskiness of the cash flows inherent in the fair value of these net assets that drive the calculation of an entity’s expected losses and expected residual returns.

The estimated cash flows of the entity should not include payments that are made to variable interest holders (i.e., absorbers of the entity’s variability). For example, Partnership X borrows money from Bank Y. Assume the debt is a variable interest. Partnership X’s estimated cash flows should not include interest or principal payments to Bank Y for purposes of calculating the entity’s expected losses and expected residual returns.
Another nuance to these calculations is excluding variable interests in specified assets. Any variable interests in specified assets of an entity that are not variable interests in the entire entity should also be identified. Expected losses absorbed and expected residual returns received by variable interests in specified assets are generally excluded from the entity’s calculation of expected losses and expected residual returns. This concept is discussed in VE 3.

1.7 Related parties and de facto agents

Excerpt from ASC 810-10-25-42 through 25-43

For purposes of determining whether it is the primary beneficiary of a VIE, a reporting entity with a variable interest shall treat variable interests in that same VIE held by its related parties as its own interests. For purposes of the Variable Interest Entities Subsection, 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.

Related-party and de facto agency relationships can play a critical role in the VIE model in two ways: (i) the determination of whether the entity is a VIE, and (ii) the determination of a VIE’s primary beneficiary, if one exists. As noted above, for the purposes of the VIE model, the related-party definition includes “de facto agency” relationships.
Related parties are defined as follows:

**Excerpt from the ASC Master Glossary**

Related parties include:

a. Affiliates of the entity

b. Entities for which investments in their equity securities would be required, absent the election of the fair value option under the Fair Value Option Subsection of Section 825-10-15, to be accounted for by the equity method by the investing entity

c. Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management

d. Principal owners of the entity and members of their immediate families

e. Management of the entity and members of their immediate families

f. Other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests

g. Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

A reporting entity, along with its affiliates, employees, agents and other related parties, may collaborate to create and manage a VIE. In expanding the definition of related parties in the VIE model to include de facto agency relationships, the intent was to prevent a variable interest holder from avoiding consolidation of a VIE by protecting its interest(s) or indirectly expanding its holdings through related parties or de facto agents. It is important to understand this rationale when evaluating the related-party guidance in the VIE model, as the application of this guidance will often necessitate judgment on the part of preparers and auditors.

While the definition of a related party is well established, the concept of de facto agents is unique and merits further discussion. Some of the de facto relationships in the VIE model are relatively straightforward. Parties are deemed de facto agents of a reporting entity if they (a) are financially dependent on the enterprise; (b) receive the investment or the funds to make the investment from the enterprise; or (c) are an officer, employee or on the governing board of the enterprise.

Under the VIE model, a de facto agency relationship is created when a party cannot sell, transfer, or encumber their interests without the approval of the reporting entity
Definition of key terms

1.7.1 Transfer restrictions

A reporting entity could avoid consolidation of a VIE by “parking” its interests with a third party and control that party’s actions by restricting its ability to sell, transfer or encumber its interest. We believe that the FASB’s rationale was to identify these situations and other situations where the restricted party (the party that must obtain approval) is acting as an agent or de facto agent on behalf of another enterprise or in the case of cross transfer restrictions may act in concert. The FASB acknowledged that the identification of these types of situations would be heavily dependent on particular facts and circumstances and that judgment is required in assessing the substance behind the approval rights contained in a particular agreement.

Whether or not transfer restrictions create a de facto agency relationship under the VIE model is dependent mainly on two factors: (a) whether or not the “restricted” party has the ability to realize (or manage) its economic interest in the entity and (b) the reasons and economic rationale behind the restrictions placed on that party. The FASB believes that a party possesses the ability to manage its economic interest if the party has the right to sell, transfer or encumber its interest in that entity without prior approval. If a party has any of these rights, a de facto agency relationship would not exist. For example, if a party has the right to sell its interest without prior approval but must obtain such approval to transfer or encumber that interest and, it is feasible that such party has the ability to realize its economics through a sale, no de facto agency relationship would exist. As mentioned previously, mutual transfer restrictions do not cause a de facto agency relationship if they are based on mutually agreed terms by willing, independent parties. This exception to the de facto agency concept for transfer restrictions may prove helpful for many joint venture arrangements that are determined to be VIEs. Many joint ventures include mutual transfer restrictions. Without providing relief in situations whereby there are mutual transfer restrictions, even if the joint venture partners were determined to have shared power, one of the parties would have been required to consolidate the entity. This result seemed to be inconsistent with the notion that no party should consolidate if there is shared power. As a result, the FASB provided an exception from the definition of de-facto agency relationships for mutual transfer restrictions.

Regarding the economic rationale behind the transfer restrictions, if the approval rights over the sale of the interest are merely to prevent the party from selling its interest to a competitor or to a less creditworthy (or otherwise less qualified) holder and there are a sufficient number of non-competitive or creditworthy buyers, the restriction would not necessarily create a de facto agency relationship. For example, a franchise agreement between the franchisee and the franchisor gives the franchisor the right to approve the sale of the franchise. If the transfer restriction is designed to
prevent the sale of the franchise to a less-than-creditworthy buyer, it would normally not create a de facto agency relationship, provided there are sufficient creditworthy, potential buyers of the franchise. In practice, the economic rationale of the approval rights or transfer restrictions may not always be evident, and considerable judgment will be involved.

Care should be used when evaluating whether a restricted party truly has the means to realize the “economics” associated with its interest in the entity. If a restricted party has the right to encumber its interest in the entity without prior approval, but due to market factors, can only borrow against a small percentage of the interest’s fair value (say, below 80 percent of its value), it would be difficult to conclude that the restricted party has the ability to realize the economics of its interest. We believe an appropriate comparison is the one described in ASC 860, Transfers and Servicing (ASC 860), which reads as follows:

**Excerpt from ASC 860-10-40-15**

Many transferor-imposed or other conditions on a transferee’s right to pledge or exchange both constrain a transferee from pledging or exchanging and, through that constraint, provide more than a trivial benefit to the transferor. Judgment is required to assess whether a particular condition results in a constraint. Judgment also is required to assess whether a constraint provides a more-than-trivial benefit to the transferor. If the transferee is an entity whose sole purpose is to engage in securitization or asset-backed financing activities, that entity may be constrained from pledging or exchanging the transferred financial assets to protect the rights of beneficial interest holders in the financial assets of the entity. Paragraph 860-10-40-5(b) requires that the transferor look through the constrained entity to determine whether each third-party holder of its beneficial interests has the right to pledge or exchange the beneficial interests that it holds. The considerations in paragraphs 860-10-40-16 through 40-18 apply to the transferee or the third-party holders of its beneficial interests in an entity that is constrained from pledging or exchanging the assets it receives and whose sole purpose is to engage in securitization or asset-backed financing activities.

If the restricted party has the ability to obtain all or most of the cash flows associated with its interest in the entity without prior approval, there is no substantive transfer restriction for purposes of this analysis.

Preparers and auditors should consider involving internal and external legal counsel, as well as the appropriate level of company management when assessing the “design” of these rights/restrictions.

Many questions have been raised in practice with regard to how the phrase “without the prior approval of the enterprise” should be applied in practice. For example, should transfer restrictions be applied generically to any circumstance whereby an approval right exists (regardless of its effect), or should one look at the level of approval required? There is no single answer and the determination depends upon the specific facts and circumstances.
1.7.1.1 Rights of first refusal

A right of first refusal exists in many arrangements and requires a variable interest holder to provide notice to another variable interest holder setting forth the price and payment terms for which a transferred interest is proposed to be sold. The non-transferring variable interest holder would have the right and option to purchase the transferring variable interest holders’ interest at the same price. We believe that a right of first refusal does not create a de facto agency relationship because the variable interest holder is not constrained from managing its economic interest in the entity.

1.7.1.2 Rights of first offer

In many circumstances, a right of first offer may exist that would require a variable interest holder to first offer to transfer its interest to another variable interest holder prior to selling it to a third party. Under these circumstances, the holder of the right of first offer would have the ability to bid to purchase the seller’s interest at a price. The seller can decide to accept or reject such bid; however, it cannot sell its interest to another party at a price lower than the price bid by the holder of the right of first offer. The right of first offer may provide some constraint over the seller’s ability to sell its interest to a party of its own choosing. However, we believe that a right of first offer provision does not create a de facto agency relationship among parties because the seller is not constrained from managing its economic interest in the entity.

1.7.1.3 Approval that cannot be unreasonably withheld

A party may have an agreement that it cannot sell, transfer, or convey its interest in the entity without the prior approval of the enterprise, and such approval cannot be unreasonably withheld. At issue is whether such a clause requiring approval that “cannot be unreasonably withheld” would result in a de facto agency relationship. As with any other transfer restriction, we believe there is a rebuttable presumption that such provisions create a de facto agency relationship. A reporting entity can overcome that presumption if (1) legal counsel can conclude that the approval right would not prevent the restricted party from selling its interest to a qualified or other third party (specifically considering the specific reasons for which approval can be withheld) and (2) there are a sufficient number of such qualified buyers to provide a non-restricted market.

1.7.1.4 Lock up periods

In certain agreements, the variable interest holders in an entity may be precluded from selling, transferring, or pledging its interest for a particular time period. For example, consider a fact pattern where Party A and Party B each own 50 percent of the equity in Entity X. Party A and Party B have entered into an arrangement whereby during the first 5 years, Party B is precluded from selling, transferring, or encumbering its interest in the entity. In this fact pattern, we believe that Party B is a de-facto agent of Party A because while there may not be explicit “prior approval” required, we believe there are implicit approval rights since in the fact pattern, Party B would need to renegotiate with Party A in order to have the right to dispose of its interest. Once the lock-up period expires, the variable interest holders are no longer considered de-facto agents which might result in a change in the primary beneficiary
conclusion. Note that in instances where there are several investors who may be precluded from selling, transferring, or pledging their interest in an entity but are represented on the board, no single party controls the board and decision-making at the board is by majority vote, the lock-up provision would not generally cause the investors to be considered as de facto agents.

1.7.2  Close business relationship

Determining whether a service provider is acting as a de facto agent of a reporting entity can also be difficult and will depend on the facts and circumstances present in each situation. This provision is necessary to prevent enterprises from avoiding consolidation by “parking” interests with a service provider, such as a lawyer or investment bank.

In the past, enterprises often worked with financial intermediaries (e.g., investment banks) to create financing vehicles that were accounted for as “off balance sheet” structures. The intermediary (or an affiliate thereof) might have decision-making abilities related to that entity through its service contract. We believe that the Board’s inclusion of close business relationships as de facto agency relationships was intended to address these types of relationships by preventing situations in which a portion of a reporting entity’s variable interest could contractually be transferred from a reporting entity to a financial advisor, a law firm, or other service provider, in an attempt to avoid consolidation of the entity. Reporting entities evaluating these relationships should consider the following factors (which are not meant to be all-inclusive):

□ Was the service provider involved with the formation of the entity?

□ Is the service provider merely acting as an intermediary between the reporting entity and the entity?

□ Is there a “round-trip” transaction through the service provider?

In addition, in a speech to the 2008 AICPA National Conference on Current SEC and PCAOB Developments, Robert Malhotra of the SEC Staff stated the following, which further elaborates key principles of the close business relationship concept:

“... 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.”
1.8 **Kick-out rights, participating rights and protective rights**

The VIE model introduced new definitions for kick-out rights and participating rights that are different than the definitions of such rights that are applicable to consolidation evaluations under the voting interest entity model.

**Excerpt from ASC 810-10-20**

*Kick-out rights* The ability to remove the reporting entity with the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance.

*Participating rights* The ability to block the actions through which a reporting entity exercises the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance.

It is important to note that both kick out rights and participating rights are defined differently under the VIE model than they are in applying the voting interest entity model. For example, approval of an operating budget is a participating right under the voting model but may not be considered a participating right under the VIE model if such right is not considered a right that most significantly impacts the entity’s economic performance. Further, we believe that protective rights under the VIE model are the opposite of participating rights and include any rights to block the actions of an enterprise that are not considered participating rights. Said another way, we believe protective rights are the ability to block the actions through which an enterprise exercises the power to direct the activities of a variable interest entity that do not most significantly impact the entity’s economic performance. The VIE model clarifies that protective rights should not be considered in assessing whether an enterprise has the power to direct activities that most significantly impact a VIE’s economic performance. Determining whether rights are protective or participating may involve significant judgment. For example, depending upon the facts, rights that are protective in the case of one entity may not be protective in the case of another entity. See VE 5.1 for more details.

Under the VIE model, only substantive kick-out and participating rights that can be unilaterally exercised by a single party (including related parties and de facto agents) should be considered in determining which enterprise, if any, is the primary beneficiary of a VIE and whether an enterprise has the power to direct activities that most significantly impact a VIE’s economic performance.

1.9 **Substantive terms, transactions, and arrangements**

The VIE model introduced the notion that only substantive terms, transactions and arrangement should be considered for purposes of applying this model as follows.
Excerpt from ASC 810-10-15-13(A)

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 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

Excerpt from ASC 810-10-15-13(B)

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.
Chapter 2:  
Scope and scope exceptions
Executive takeaway

- The variable interest entity consolidation model typically only applies when the reporting entity has a variable interest in a legal “entity.”

- There is no blanket scope exception for entities that meet the definition of a business. The business scope exception contains a number of requirements which are often difficult to meet.

- The VIE model eliminated the scope exception for reporting entities with interests in qualifying special purpose entities.

- Other scope exceptions exist for certain not-for-profits, certain employee benefit plans, certain governmental organizations, as well as certain investment companies.

- The FASB deferred the VIE model as amended by ASU 2009-17 for certain investment entities that have the attributes of entities subject to ASC 946 (the “investment company guide”). The deferral also applies to registered money market funds as well as all other (unregistered) funds that operate in a similar manner as registered money market funds. For these entities subject to the deferral, the pre-amended VIE model consolidation analysis (formerly FIN 46(R)) should be applied.

- The FASB is currently in the process of re-deliberating a proposal that would remove the deferral of the VIE model as amended by ASU 2009-17 (FAS 167) for investment companies. A final standard is expected in the second half of 2013.
This chapter provides an overview of the types of entities that are within the scope of the Variable Interest Entities Subsections of ASC 810-10, Consolidation—Overall (the VIE model). Critical to this assessment is (1) whether or not the variable interest held is in a legal entity and (2) whether or not that legal entity has been specifically scoped out of the VIE model. There are very few exceptions, and, unless specifically scoped out, all entities must be evaluated under its provisions. It is important to note that with the issuance of ASU 2009-17 the FASB eliminated the scope exception for qualifying special purpose entities (QSPEs) that was previously available. As a result, QSPEs and their affiliates are no longer scoped out of the VIE model. The FASB deferred the VIE model as amended by 2009-17 for certain investment entities that have the attributes of entities subject to ASC 946. This deferral also applies to registered money market funds as well as all other (unregistered) funds that operate in a similar manner as registered money market funds. See VE 2.3 for more details.

2.1 Definition of an entity

In general, the VIE model applies to all legal entities, regardless of whether the entity is a special purpose entity (SPE). The definition of a legal entity and certain clarifications as applicable to the VIE model are as follows:

**Excerpt from ASC Master Glossary**

**Legal Entity**

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

**Excerpt from ASC 810-10-15-15**

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 subsections and may be VIEs.

The definition of legal entity includes all legal structures established to manage or administer activities of any kind or to hold assets or liabilities. Many people fail to realize the broad applicability of this concept. For example, the following types of entities would all qualify as entities under the VIE model:

- Corporations
- Partnerships
- Other unincorporated entities
- Limited liability companies
The VIE model applies to legal entities that are used to conduct activities or to hold assets. It does not apply to arrangements between individuals. Concluding that an arrangement involves a legal entity necessitates evaluating the relevant facts of the transaction. Following are examples that illustrate the importance of evaluating all of the facts prior to concluding that the guidance in the VIE model does not apply:

- A franchise agreement may be entered into between the franchisor and an individual. This arrangement does not fall within the scope of the VIE model. On the other hand, if the franchise agreement is between the franchisor and a legal entity (e.g., a corporation, partnership, LLC, or unincorporated entity), that entity falls within the scope of the VIE model.

- In the insurance industry, it is common practice to use syndicates to accept insurance business on behalf of the members of the syndicate. Depending on the legal form of the structure, some syndicates may fall within the scope of the VIE model, since the activities take place in a legal entity (e.g., a partnership), while other syndicates may be scoped out of these subsections because there is no legal form in which they conduct their underwriting activities.

Following are factors that may be considered when evaluating whether a structure is a legal entity:

- Does the structure meet the definition of a legal entity in the resident country? If not, does the structure have characteristics similar to those of a legal entity in the U.S. For example, does the unincorporated foreign joint venture have characteristics similar to those of a U.S. partnership or LLC?

- Is the structure/entity permitted to enter into contracts under its own name (i.e., not in the name of the partners or parent company)?

- Can the structure sue or be sued in its own name?

- Is the liability of the partners limited or do the liabilities of the structure flow through to the partners?

- Is the structure recognized for tax purposes? Is a tax return filed in the structure's name?

- Is the structure able to open a bank account in its own name?

Prior to assessing these factors, it may be necessary to seek the legal advice of an attorney to fully understand the characteristics of the structure (i.e., to understand what the structure can and cannot do). Additionally, it is possible that one indicator may not be conclusive in evaluating that the entity is in fact, a legal entity. Therefore, all of the factors should be considered.
“Virtual SPEs” (divisions, departments, branches, or pools of assets subject to liabilities that are otherwise nonrecourse to the reporting entity) are excluded from the scope of the VIE model because they are not separate legal structures from the entity that holds title to the assets. However, there are certain rules that may require virtual SPEs or “silos” to be consolidated. Silos are discussed in more detail in VE 3.6.

**Majority-owned or wholly-owned subsidiaries**

Even a wholly- or majority-owned subsidiary (that is, a legal entity separate from the parent’s legal entity) is subject to the VIE model and may be a variable interest entity (VIE). If the subsidiary is a VIE, it is possible that a reporting entity, other than the subsidiary’s legal parent, may be required to consolidate it. In this case, the owner of a majority (or all) of the voting rights may be required to deconsolidate its subsidiary.

Consider the following example:

- Reporting Entity A holds a majority of the voting rights of Entity XYZ and had appropriately consolidated Entity XYZ pursuant to the voting interest guidance in ASC 810-10.
- Entity XYZ entered into certain contractual arrangements with Reporting Entity B that transfer to Reporting Entity B certain risks and rewards relative to all of the activities of Entity XYZ.
- Reporting Entity B has **not** made any equity investments in Entity XYZ.

Since consolidated subsidiaries are not exempt from the VIE model, the parent and other parties that hold interests in Entity XYZ must determine whether it is a VIE. It does not matter whether or not Reporting Entity B has any equity investment in Entity XYZ. Therefore, Reporting Entity A and Reporting Entity B must re-evaluate whether either reporting entity should consolidate Entity XYZ. This situation represents an example of how the analysis of consolidation accounting regarding any entity must **begin** with the VIE model. The other subsections in ASC 810 would apply only after concluding that Entity XYZ is not a VIE subject to the scope of the VIE model.

### 2.2 Scope exceptions

The VIE model provides for certain scope exceptions. Although these scope exceptions appear straightforward, we believe that their application necessitates thoughtful judgment and consideration. The reporting entity must continually assess whether or not it still qualifies for the scope exceptions.

#### 2.2.1 The “so-called” business scope exception

One of the more confusing aspects is determining whether the VIE model applies to an entity that meets the definition of a business. The VIE model provides the following scope exception (the “business scope exception”) for reporting entities with variable interests in an entity:
Excerpt from ASC 810-10-15-17(d)

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

1. The reporting entity, its related parties (all parties identified in paragraph 810-10-25-43, except for de facto agents under paragraph 810-10-25-43(d)), or both participated significantly in the design or redesign of the legal entity. However, this condition does not apply if the legal entity is an operating joint venture under joint control of the reporting entity and one or more independent parties or a franchisee.

2. The legal entity is designed so that substantially all of its activities either involve or are conducted on behalf of the reporting entity and its related parties.

3. The reporting entity and its related parties provide more than half of the total of the equity, subordinated debt, and other forms of subordinated financial support to the legal entity based on an analysis of the fair values of the interests in the legal entity.

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

The objective of the VIE model is to provide guidance to address situations where the “voting interest” approach is not effective in identifying a party that has a controlling financial interest in an entity. The Board was specifically opposed to a scope exception for all businesses, citing that such a distinction was contrary to the principle underlying the VIE model. Therefore, an assumption that these subsections provide a scope exception to all businesses is not correct and many entities that are businesses may be VIEs.

We believe that the objective of the business scope exception is to allow reporting entities to avoid applying the VIE model to entities when it is unlikely that the reporting entity would be required to consolidate the entity (as the primary beneficiary) even if the entity is a VIE. The Board considered the most useful way to provide this aid to implementation would be in the form of a scope exception, that is, in a list of conditions that, if met, would obviate the need for further analysis and application of this guidance.

The criteria in the business scope exception focus on the relationships between the reporting entity and the entity, rather than on whether the entity has the characteristics of a VIE, as specified in ASC 810-10-15-14. Each reporting entity with an interest in the entity will separately need to evaluate its own relationships with the entity. The fact that one reporting entity concludes that it is eligible for the business scope exception does not provide a basis for any other entity to conclude that the entity is not a VIE. In fact, one reporting entity may conclude that it meets the
business scope exception, while another entity may not be eligible for the scope exception and may conclude that the entity is a VIE.

Although the evaluation under the business scope exception may seem straightforward, it is not. It involves evaluating several factors in addition to the specific facts and circumstances of the transaction. The first step is to determine whether or not the entity is a business. The second step is to determine whether or not any of the four conditions in the business scope exception are met. If any are met, the reporting entity is precluded from utilizing the scope exception. If a reporting entity concludes that the business scope exception is met, it implies that the reporting entity should evaluate whether or not the business scope exception is met at each subsequent reporting period. The guidance below includes some of the significant matters for consideration when assessing the business scope exception.

What is a “Business?”

In order to apply the business scope exception, the reporting entity must determine whether or not the entity is a business. The guidance for accounting for business combinations is located in ASC 805, Business Combinations (ASC 805). ASC 805-10-55-4 through 55-9 state that the definition of a business for use in the VIE model is as follows:

**Excerpts from ASC 805-10**

20: A business is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants.

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.

ASC 805-10-55-5: 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.

ASC 805-10-55-6: 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.

ASC 805-10-55-7: 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.

ASC 805-10-55-8: 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.

ASC 805-10-55-9: 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.
An entity that meets the definition of a business does not need to be evaluated by the reporting entity unless one or more of the following conditions are met:

**Condition 1: Design of the entity**

**Excerpt from ASC 810-10-15-17-(d)(1)**

The reporting entity, its related parties (all parties identified in paragraph 810-10-25-43, except for de facto agents under paragraph 810-10-25-43(d)), or both participated significantly in the design or redesign of the legal entity. However, this condition does not apply if the legal entity is an operating joint venture under joint control of the reporting entity and one or more independent parties or a franchisee.

This condition (the “design of the entity” condition) requires an understanding of the dynamics involved in the design (or redesign) of the entity being evaluated. Indicators that the reporting entity was involved in the design (or redesign) of the entity include input to activities involving

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

If the capital structure, governance structure and/or operating activities are significantly revised as a result of the reporting entity’s involvement with the entity being evaluated or shortly thereafter then the entity has been substantively redesigned. Moreover, the reporting entity must identify whether its related parties participated in these activities. If so, this scope exception may not be available. For purposes of evaluating the design of the entity condition, related parties include de facto agents identified in ASC 810-10-25-43, except for de facto agents under ASC 810-10-25-43(d) as a result of transfer restrictions (refer to VE 1.7 for a discussion of related parties and de facto agents).

In addition, when an entity undergoes a redesign or restructuring, the reporting entity must re-evaluate this condition (refer to VE 4.3 for discussion of reconsideration events of the VIE’s status).

There are two exceptions to the design of the entity condition:

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

To qualify for this exception, the entity must meet the definition of a joint venture as defined in the ASC Master Glossary, “An entity owned and operated by a small group of entities (the joint venturers) as a separate and specific business or project for the mutual benefit of the members of the group,” (the 1979 AcSEC Issues Paper, Joint Venture Accounting also provides guidance for determining which entities are operating joint ventures). Joint control over decision making is the most significant
attribute of a joint venture. Under the design of the entity condition, it is critical that the reporting entity and at least one other unrelated party jointly control the entity. This means that neither party may have unilateral control. For example, if one joint venture partner (or another party) controls an entity through an operating or management agreement, the reporting entity would be required to apply the VIE model. A distinguishing feature of a corporate joint venture is joint control. Joint control requires that all venturers consent to the major decisions of the entity. For example, an entity with three or more shareholders where decisions are made by majority is not a joint venture. While not specifically addressed as part of the exception to the design of the entity condition for joint ventures, given the principles in the guidance, preparers should consider whether evaluating the power to direct activities of the entity that have a significant impact on the entity’s performance (i.e., consistent with the primary beneficiary analysis) is jointly controlled.

Although joint control is a key defining feature of a corporate joint venture, the existence of joint control is not the only determinant when identifying whether an entity is a joint venture. Other factors must also be present to distinguish a corporate joint venture from other entities (such as those discussed in the ASC Master Glossary). Lastly, operating joint ventures must still be evaluated under the remaining conditions of the business scope exception prior to utilizing this scope exception.

Franchise Agreements, as defined in the Master Glossary contained in the FASB codification:

While all franchisee entities would meet the design condition of the entity, the Board does not believe that entities holding franchise agreements are, by definition, VIEs. Therefore, to alleviate the burden of applying the VIE model to franchises, the Board decided that the design of the entity condition should not apply to an entity that is a franchise. Franchisee entities must still be evaluated under the remaining conditions of the business scope exception prior to utilizing the business scope exception.

Condition 2: The “Substantially All” test

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

The legal entity is designed so that substantially all of its activities either involve or are conducted on behalf of the reporting entity and its related parties.

This condition (the “substantially all” condition) attempts to address those entities that have a narrow business purpose because they were designed to complement the reporting entity’s operating or financing activities. Most questions regarding this condition concern how the phrase “substantially all of its activities either involve or are conducted on behalf...” should be interpreted. This is the same phrase that is used in connection with entities established with non-substantive voting rights, and thus we believe that this condition should be interpreted in a consistent manner.

The phrase “substantially all of the entity’s activities either involve or are conducted on behalf...” is often misinterpreted as to whether or not substantially all of the activities are conducted on behalf of the reporting entity and its related parties,
which overlooks whether the activities involve the reporting entity or its related parties.

As a general rule, we believe that this assessment is primarily qualitative. Some have suggested that the phrase substantially all should be interpreted to mean that 90 percent or more of the economics of the entity relate or accrue to the benefit of a particular party. We do not share this view. Rather, we believe that such a quantitative measure is only one of many factors that should be considered in evaluating this criterion. However, we recognize there may be circumstances where the economics of the arrangement are so skewed in the direction of one reporting entity that a quantitative analysis may in and of itself override other considerations.

We often use the following list of indicators in our evaluation:

<table>
<thead>
<tr>
<th>Strong indicators*</th>
<th>Other indicators*</th>
</tr>
</thead>
<tbody>
<tr>
<td>□ The reporting entity sold assets to the entity in an effort to remove underperforming assets from the reporting entity’s balance sheet.</td>
<td>□ The reporting entity sold assets to the entity.</td>
</tr>
<tr>
<td>□ The entity’s major activities include selling substantially all of its products to the reporting entity under long-term contracts.</td>
<td>□ The entity’s major activities include selling a majority of its products to the reporting entity, and such relationship is expected to continue either because of long-term contracts or for other reasons.</td>
</tr>
<tr>
<td>□ The entity’s major activities include purchasing substantially all of its purchased products from the reporting entity.</td>
<td>□ The entity’s major activities include purchasing a majority of its purchased products from the reporting entity.</td>
</tr>
<tr>
<td>□ The reporting entity holds a non-reciprocal, fixed-price or “in the money” call option on the other investors’ equity investments, and/or the other investors have a fixed-price or “in the money” put option whereby they can put their investments to the reporting entity.</td>
<td>□ The reporting entity holds a non-reciprocal (or fair-value) call option on the other investors’ equity investments, and/or the other investors have a similarly priced, non-reciprocal put option.</td>
</tr>
<tr>
<td>□ The reporting entity is obligated to provide substantially all of any additional capital contributions that may be necessary to cover operating shortfalls.</td>
<td>□ The reporting entity is obligated to provide a majority of any additional capital contributions that may be necessary to cover operating shortfalls.</td>
</tr>
</tbody>
</table>
### Scope and scope exceptions

<table>
<thead>
<tr>
<th>Strong indicators*</th>
<th>Other indicators*</th>
</tr>
</thead>
<tbody>
<tr>
<td>□ The entity performs research and development activities, and the reporting entity has an economic interest (e.g., through a purchase option) in the results of the research that constitutes <strong>substantially all</strong> of the entity's activities.</td>
<td>□ The entity performs research and development activities, and the reporting entity is in a business that could capitalize on the results of the research that constitutes a <strong>majority</strong> of the entity's activities.</td>
</tr>
<tr>
<td>□ The reporting entity has outsourced operations to the entity, constituting <strong>substantially all</strong> of the entity's activities.</td>
<td>□ The reporting entity has outsourced operations to the entity, constituting a <strong>majority</strong> of the entity's activities.</td>
</tr>
<tr>
<td>□ <strong>Substantially all</strong> of the entity’s assets are leased to the reporting entity.</td>
<td>□ A <strong>majority</strong> of the entity’s assets are leased to the reporting entity.</td>
</tr>
<tr>
<td>□ The principal activity of the entity is to provide financing (e.g., loans or leases) to the reporting entity’s customers.</td>
<td>□ A <strong>majority</strong> of the entity’s activities involve providing financing (e.g., loans or leases) to the reporting entity’s customers.</td>
</tr>
<tr>
<td>□ The principal purpose of the entity is to conduct a business that is uniquely complementary to a significant business operation of the reporting entity and is not similar to activities of other participants in the entity.</td>
<td>□ The principal purpose of the entity is to conduct a business that is more closely related to a significant business operation of the reporting entity and only broadly similar to activities of one or more of the other participants in the entity.</td>
</tr>
<tr>
<td>□ The economics (e.g., capital at risk, participation in profits, etc.) are heavily skewed (e.g., close to 90 percent or greater) toward the reporting entity.</td>
<td>□ The economics (e.g., capital at risk, participation in profits, etc.) are weighted (e.g., greater than 60 percent) toward the reporting entity.</td>
</tr>
</tbody>
</table>

* With respect to evaluating these indicators, the term reporting entity covers the reporting entity’s related parties (as defined in ASC 810-10-25-43, other than those de facto agents resulting from ASC 810-10-25-43(d)).

There are no broad “rules of thumb” that can be used to shortcut the evaluation required for the substantially all condition. Instead, reporting entities will need to evaluate the relevant facts and circumstances surrounding each individual situation. Absent mitigating factors (e.g., indicators that point to a different conclusion), we believe that the presence of a single item from the “Strong Indicators” column may, at times, be sufficient to support a conclusion that substantially all of the activities of the entity either involve or are conducted on behalf of the reporting entity. At other times,
multiple strong indicators may need to be present to reach the same conclusion. There are no “bright lines” and this assessment requires judgment. If the reporting entity meets several of the “Other Indicators,” it may need to seriously consider whether or not the requirements of the substantially all condition have been met, and consultation with an accounting professional familiar with these provisions may be appropriate.

Franchise agreements entered into by a franchisor with a franchisee often possess unique attributes in order to protect the franchise brand. As a result, the criterion in the substantially all condition must be carefully analyzed. The table on the previous page should prove useful when evaluating whether a franchise is designed so that substantially all of its activities either involve or are conducted on behalf of the franchisor. However, there may be other factors to consider in the franchise relationship, including the ability to select and set pricing of the menu (or products sold by the franchise) and other factors, some of which are described in more detail in ASC 952, Franchisors (ASC 952), specifically in ASC 952-810-55-2.

**Condition 3: Subordinated financial support**

**Excerpt from ASC 810-10-15-17(d)(3)**

The reporting entity and its related parties provide more than half of the total of the equity, subordinated debt, and other forms of subordinated financial support to the legal entity based on an analysis of the fair values of the interests in the legal entity.

Subordinated financial support is defined under the VIE model as “variable interests that will absorb some or all of a variable interest entity’s (VIE’s) expected losses.” Therefore, virtually any variable interest in the entity is considered subordinated financial support. Consequently, reporting entities making this evaluation must consider all variable interests they and other parties have with the entity, including variable interests in the form of guarantees, management contracts, derivatives, purchase options, and supply contracts, as well as loans and equity investments. This will not be easy since fair-value information is often not available. Therefore, we believe that this assessment may be difficult to perform, particularly in situations where the various forms of financial support provided to the entity by the reporting entity are substantial. Therefore, from a practical perspective, this scope exception would generally be available when it is obvious that the reporting entity would not absorb the majority of the economics of the entity on a fair value basis. For many arrangements, such as for example, 50:50 ventures, it will be difficult to make this assertion. In a 50:50 venture, while the economics are intended to be shared on a 50:50 basis, it may not be the case in practice. There are often commercial arrangements between the venturers and the venture that may be variable interests and it becomes very hard to establish without a complex analysis that the economics with respect to all the variable interests held by the venturers are split exactly on a 50:50 basis. Therefore, the entity will more often than not need to be evaluated under the VIE model.
Condition 4: Common financing structures

Excerpt from ASC 810-10-15-17(d)(4):
The activities of the legal entity are primarily related to securitizations or other forms of asset-backed financings or single-lessee leasing arrangements.

This condition (the “common financing structure” condition) is the most straightforward. The primary logic for including this criterion is to ensure that entities that were previously considered “typical” SPE structures are always assessed under the VIE model. In applying this condition, we believe the phrase “single-lessee leasing arrangements” should be interpreted broadly. Therefore, it includes entities that have entered into long-term supply arrangements that contain an embedded lease under ASC 840-10-15-6. In fact patterns where an entity is deemed to be a single-lessee leasing arrangement, the reporting entity would not be eligible for this scope exception.

2.2.2 Not-for-profit organizations

Excerpt from ASC 810-10-15-17(a)
Not-for-profit entities (NFPs) are not subject to the Variable Interest Entities Subsections, except that they may be related parties for purposes of applying paragraphs 810-10-25-42 through 25-44. In addition, if an NFP is used by business reporting entities in a manner similar to a VIE in an effort to circumvent the provisions of the guidance in the Variable Interest Entities Subsections, that entity shall be subject to the guidance in the Variable Interest Entities Subsections.

This scope exception applies to all not-for-profit entities/reporting entities (NFPs) that are subject to the consolidation requirements in ASC 958, Not-for-Profit Entities—Consolidation (ASC 958). The exception also applies to NFP health care organizations subject to the AICPA’s Audit and Accounting Guide, Heath Care Organizations. Under this scope exception:

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

- A for-profit reporting entity does not have to apply the VIE model to a NFP unless the NFP was established to avoid consolidation under the VIE model. In the latter case, a for-profit reporting entity with a relationship with a NFP entity would need to apply the VIE model in assessing whether or not the NFP is a VIE, and if it is a VIE, identify the primary beneficiary.

Despite this exception, a NFP reporting entity must be considered a related party to a reporting entity (i.e., a for-profit reporting entity) when that reporting entity is assessing whether or not it is the primary beneficiary of a VIE. Refer to VE 1.7 for a further description of related parties.
A for-profit reporting entity could use certain leasing structures involving NFPs to circumvent the provisions of the VIE model. In these cases, the scope exception would not apply. In most cases, we would not expect a NFP charitable foundation that was established by a reporting entity to be subject to the VIE model.

Although EITF 90-15, *Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions* (EITF 90-15), was nullified by the guidance in the Variable Interest Entities subsections of ASC 810-10 for entities within the scope of that guidance, we believe that NFP entities previously evaluated by way of analogy to EITF 90-15 should continue to be evaluated in that manner.

### 2.2.3 Employers that offer employee benefit plans

**Excerpt from ASC 810-10-15-12(a)**

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

Although an employer that sponsors an employee benefit plan is not required to consolidate that plan, the exception does not specifically provide a scope exception to employee benefit plans (i.e., the VIE model may apply to interest/investments in entities held by the plan). However, defined-benefit plans that fall within the scope of ASC 960, *Plan Accounting—Defined Benefit Pension Plans* (ASC 960), should continue to follow the guidance of ASC 960 and are not subject to the VIE model. Additionally, the scope exception would not be available to a service provider (who is not the sponsoring employer). We do not believe that it was the FASB’s intent to require employee benefit plans to consolidate entities in which they invest.

### 2.2.4 Investment companies

**Excerpt from ASC 810-10-15-12(d)**

Investments accounted for at fair value in accordance with the specialized accounting guidance in Topic 946 are not subject to consolidation according to the requirements of this Topic.

This scope exception only applies to investments that are owned by a reporting entity that qualifies as an Investment Company under the guidance of ASC 946. **It does not apply to non-investment companies that hold interests in such an Investment Company.**

The AICPA issued Statement of Position 07-1, *Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies* (SOP 07-1), in an attempt to clarify whether an entity is within the scope of the AICPA Audit and Accounting Guide, *Investment Companies* (the Audit Guide), and, for those entities that are within the scope of the Audit Guide, address whether the specialized accounting in the Audit Guide should be retained by a noninvestment company parent.
or equity method investor of an Investment Company. The original effective date, fiscal years beginning on or after December 15, 2007, with earlier adoption encouraged, was indefinitely deferred by FSP SOP 07-1-1, Effective Date of AICPA Statement of Position 07-1.

An entity that early adopted SOP 07-1 is allowed to continue to follow this guidance in which case, at each reporting period end, the parent (i) will first need to evaluate whether or not the subsidiary or equity method investee continues to qualify as an Investment Company per SOP 07-1, and (ii) determine if the parent is able to retain the specialized accounting in consolidation. If the parent company is unable to retain the specialized accounting in consolidation, the parent company will then need to evaluate each investee of the consolidated entity under the applicable guidance.

For those entities that did not early adopt SOP 07-1 but invest in entities that follow the specialized accounting in the Audit Guide, the investee entity is not required to consider whether any of the investee entity’s investments are VIEs potentially requiring consolidation under the VIE model. The parent of such a consolidated entity retains the specialized accounting in consolidation under EITF Issue No. 85-12, Retention of Specialized Accounting for Investments in Consolidation, and EITF Topic D-74, Issues Concerning the Scope of the AICPA Guide on Investment Companies.

The FASB and IASB are currently working on a joint project to provide comprehensive guidance for assessing whether an entity is an investment company and to provide measurement requirements for an investment company’s investments. The FASB and IASB are redeliberating certain aspects of their proposal and preparers should continue to monitor developments of this project.

Reporting entities such as investors, managers and other parties that hold an interest in an entity that follows the specialized accounting in the Audit Guide need to consider whether the entity itself is a VIE potentially requiring consolidation under the VIE model. If the reporting entity determines that it is required to consolidate the entity under the VIE model, it then needs to apply the discussion in the paragraphs above to determine whether or not the reporting entity is required to apply the VIE model to each investee of the consolidated entity.

2.2.5 Separate accounts of life insurance entities

**Excerpt from ASC 810-10-15-17(b)**

Separate accounts of life insurance entities as described in Topic 944 are not subject to consolidation according to the requirements of the Variable Interest Entities Subsections.

This scope exception indicates that separate accounts of life insurance companies are not subject to consolidation by another reporting entity. The Board chose not to change current GAAP for separate accounts of life insurance companies without a broader reconsideration of accounting by insurance entities, which is beyond the scope of the VIE model. Separate accounts that are governed by SEC Regulation S-X,
Rule 6-03(c)(1) are eligible for the same scope exception as other registered investment companies. Non-registered separate accounts that are subject to the Audit Guide should consider the discussion in VE 2.2.4 above.

Note that the scope exception for the separate accounts as discussed above is not applicable to the general account of the insurers. Therefore, insurers should include variable interests associated with the general account when determining the primary beneficiary of an investment fund under the VIE model.

2.2.6 “Information-out”

Excerpt from ASC 810-10-15-17(c)

A reporting entity with an interest in a VIE or potential VIE created before December 31, 2003, is not required to apply the guidance in the Variable Interest Entities Subsections to that VIE or legal entity if the reporting entity, after making an exhaustive effort, is unable to obtain the information necessary to (1) determine whether the legal entity is a VIE, (2) determine whether the reporting entity is the VIE’s primary beneficiary, or (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.

The FASB recognized that there may be instances where reporting entities have entered into arrangements prior to December 31, 2003 and are unable to obtain the information necessary to apply the VIE model. Oftentimes, the reporting entity may not have the contractual or legal right to the information necessary to apply the VIE model, and the entity is unwilling to supply the information to the reporting entity. The FASB has indicated that it expects such instances to be infrequent, especially if the reporting entity was involved in the design of the entity or if the reporting entity is exposed to substantial risks of the entity. The FASB declined to provide examples or further explain the term exhaustive as it is used in this context. The reporting entity must also continue to make exhaustive efforts to obtain the necessary information in subsequent periods. ASC 810-10-65 provides transition guidance for subsequent adoption when the reporting entity obtains the necessary information to apply the provisions of the VIE model (refer to VE 8.1 for a discussion of the transition guidance).

As reporting entities enter into arrangements with new entities or change arrangements with existing entities, they should ensure that they obtain the right to access the information that is necessary for applying the provisions of the VIE model.
Additionally, if a reporting entity avails itself of this exception, it is required to make the following additional disclosures required by the VIE model as amended by (refer to VE 7):

**Excerpt from ASC 810-10-50-6**

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 810-1015-17(c) shall disclose the following information:

a. The number of legal entities to which 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.

At the 2003 AICPA National Conference on Current SEC Developments, Eric Schuppenhauer of the SEC staff stated:

*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...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.*
At the 2004 AICPA National Conference on Current SEC Developments, Jane Poulin of the SEC stated:

*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.*

Given the Staff’s comments and the FASB’s current views on the “information-out” exception, we anticipate that the use of this scope exception will be rare and reporting entities using this exception will come under scrutiny.

If the “information-out” scope exception has been previously applied and the information subsequently becomes available the VIE model must be applied (i.e., the scope exception is no longer available). If the reporting entity has determined that the entity being considered for consolidation is a VIE and the reporting entity is the primary beneficiary, then the reporting entity may consolidate the entity through a cumulative effect of an accounting change or a restatement of prior periods, which is described in ASC 810 (see VE 8.1 for more details).

### 2.2.7 Governmental organizations

**Excerpt from ASC 810-10-15-12(e)**

A reporting entity shall not consolidate a governmental organization and shall not consolidate a financing entity established by a governmental organization unless the financing entity (1) is not a governmental organization and (2) is used by the business entity in a manner similar to a VIE in an effort to circumvent the provisions of the Variable Interest Entity subsections.
In most cases, a reporting entity subject to the VIE model shall not consolidate a governmental organization or a financing entity established by a governmental organization. The term governmental organization is described in the AICPA Audit and Accounting Guide, *Audits of State and Local Governments*, 1.01 and 1.02, which states the following:

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**Excerpt from AICPA Audit and Accounting Guide, Audits of State and Local Governments, 1.01 and 1.02**

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

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

Furthermore, entities are presumed to be governmental if they have the ability to issue directly (rather than through a state or municipal authority) debt that pays interest exempt from federal taxation. However, entities possessing only that ability (to issue tax-exempt debt) and none of the other governmental characteristics may rebut the presumption that they are governmental if their determination is supported by compelling, relevant evidence.

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

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*Black's Law Dictionary* defines a public corporation as: “An artificial person (e.g. [a] municipality or a governmental corporation) created for the administration of public affairs. Unlike a private corporation it has no protection against legislative acts altering or even repealing its charter. Instrumentalities created by [the] state, formed and owned by it in [the] public interest, supported in whole or part by public funds, and governed by managers deriving their authority from [the] state.” *Sharon Realty Co. v. Westlake, Ohio Com. Pl., 188 N.E.2d 318, 323, 25, O.O.2d 322*. A public corporation is an instrumentality of the state, founded and owned in the public interest, supported by public funds and governed by those deriving their authority from the state. *York County Fair Ass’n v. South Carolina Tax Commission, 249 S.C. 337, 154 S.E.2d 361, 362.*
This definition should be carefully considered when applying this scope exception. This scope exception requires that a reporting entity should apply the VIE model to a financing entity that is created by a governmental organization if

- the financing entity was established in order for the reporting entity to circumvent the provisions of the model; and,

- the financing entity is not itself a governmental organization.

Since the Governmental Accounting Standards Board (GASB) establishes the accounting rules for state and local governmental organizations, the VIE model does not apply to a governmental organization when assessing whether or not that governmental organization should consolidate another entity.

Examples of situations covered by this exception include, but are not limited to, (i) the issuance of tax-exempt debt by a governmental organization (or a financing entity established by a governmental organization) to finance the construction of an asset leased to the reporting entity and (ii) a tax-increment financing entity established by a municipality to finance certain infrastructure assets on land that is owned by the reporting entity (commonly referred to as industrial development bonds).

In practice, the governmental scope exception is difficult to apply particularly when dealing with an entity that is a financing entity that has been established by a governmental organization.

### 2.3 Deferral of the 2009 revisions to the VIE model for certain investment entities

On February 25, 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update 2010-10 (“ASU 2010-10”) to defer the VIE model as amended by ASU 2009-17 for certain investment entities that have the attributes of entities subject to ASC 946 (the “investment company guide”). The deferral amends the guidance in the VIE model as amended by ASU 2009-17 to defer its effective date for entities that meet the following conditions:

1. The entity either:

   - Has all of the attributes specified in ASC 946-10-15-2(a) through (d) (i.e., the attributes of an entity that would be considered subject to investment company accounting) or,

   - Does not have all of the attributes specified in ASC 946-10-15-2(a) through (d), but is an entity for which it is industry practice to apply guidance consistent with the measurement principles in ASC 946 (including recognizing changes in fair value currently in the statement of operations) for financial reporting purposes.
2. The reporting enterprise does not have an explicit or implicit obligation to fund losses of the entity that could potentially be significant to the entity. This condition should be evaluated considering the legal structure of the reporting enterprise’s interest, the purpose and design of the entity, and any guarantees provided by the reporting enterprise’s related parties.

3. The entity is not a securitization entity, an asset-backed financing entity, or an entity formerly considered a qualifying special-purpose entity.

The deferral is not optional. In order for an entity to be subject to the deferral, all three conditions must be met on the date the reporting entity adopts the VIE model as amended by ASU 2009-17. If the conditions are no longer met after the reporting entity has adopted the VIE model as amended by ASU 2009-17, the reporting entity must apply the provisions of the VIE model as amended by ASU 2009-17 to the entity, and the entity cannot re-qualify for the deferral in the future.

Even though an entity may initially be subject to the deferral, a subsequent change in facts and circumstances may result in it ceasing to qualify. Accordingly, reporting entities will need to establish a process to monitor ongoing qualification for the deferral.

Obligation to fund losses

The deferral does not apply to situations in which the reporting entity could be required to fund losses of the entity, including through either an implicit or explicit guarantee that could potentially be significant to the entity, other than money market funds as noted below. Determining whether a reporting entity has the obligation to absorb losses that could potentially be significant to an entity requires judgment and should consider all facts and circumstances related to the terms and characteristics of a reporting entity’s interest or interests in the entity along with the design and characteristics of the entity.

The determination of whether a limited partnership meets the conditions for the deferral will require careful analysis. The FASB has indicated that a general partner’s unlimited legal liability would not necessarily by itself disqualify the limited partnership for the deferral, but that additional analysis would be required. Under partnership law in the United States, the general partner has joint and several liability for all obligations of the limited partnership, unless otherwise agreed to by a claimant (e.g., a creditor) or provided by law.

In many situations (e.g., where the limited partnership has outstanding debt), the general partner interest is held by a “blocker entity” (e.g., an LLC) designed in a manner to limit the general partner’s unlimited legal liability. That is, the blocker entity (1) sits between the investment manager and the limited partnership and (2) has no other substantive assets that provide it with the wherewithal to make good on the obligations of the limited partnership if called upon. ASU 2010-10 states that if a reporting enterprise’s exposure to the obligations of a partnership is limited based on the legal structure, the limited partnership may meet the conditions for the deferral. As a result, we generally believe that the existence of such a blocker entity would allow the general partner to conclude that its legal liability is limited, and therefore, it does
not have an obligation to fund losses of the entity (i.e., the limited partnership) that could potentially be significant.

If a blocker entity does not exist, additional analysis may be warranted. ASU 2010-10 states that both the purpose and design of the entity and any guarantees provided by the general partner and its related parties, as well as the legal structure of the limited partnership should be considered in the analysis. For example, debt issued by a limited partnership should be assessed to determine if the general partner is in effect (through its legal liability) guaranteeing the debt or if the debt has sole recourse to assets of the entity (and therefore no recourse to the general partner). If the general partner is in effect guaranteeing the debt, the potential significance of the guarantee should be evaluated regardless to its probability of being funded. The limited partnership would not meet the conditions for the deferral if the guarantee is determined to be potentially significant, unless a blocker entity is in place.

Given the overall design of most investment partnerships, we would not expect a general partner’s unlimited legal liability to cover general administrative liabilities (e.g., legal or audit fees) and potential liabilities from general lawsuits to represent risks that the entity was designed to pass along to its interest holders. Accordingly, we would generally expect that these types of implicit guarantees will not prevent an entity from meeting the conditions for the deferral.

Many investment funds include “claw back” arrangements whereby previous performance distributions from the limited partnership to the general partner (investment manager) may need to be returned, because the performance fee is no longer being earned. As mentioned above, the FASB decided that the expected performance of the entity over its life along with its nature and design should be considered in making the determination as to whether the reporting enterprise (i.e., the general partner) has an obligation to fund losses of the entity that could be potentially significant. Accordingly, claw back arrangements, where an investment manager may be required to refund prior fees to the entity, may not violate the conditions for the deferral.

Similarly, any future capital commitments required to be made by the reporting enterprise to the entity should be analyzed to determine whether they represent the funding of future investments or the funding of prior losses. This determination should be based on the facts and circumstances. If a capital commitment is determined to be a funding of investments as the investment manager finds suitable investments, it would not violate the conditions for the deferral. If, on the other hand, a capital commitment is determined to be a funding of prior losses, it would violate the deferral conditions even if all investors were funding the losses on a pro-rata basis.

Determining whether capital commitments are the funding of future investments or the funding of prior losses may be challenging. For example, a reporting enterprise may choose to fund losses by having the entity issue a subordinate class of equity such that the holder of that class will in essence fund the initial or continuing losses of the entity. In such a case, if the reporting enterprise acquires the subordinate class of equity, this may violate the deferral conditions. Reporting entities may want to consider the guidance in ASC 323-10-35-29 (formerly EITF 02-18) to determine
whether a capital commitment represents the funding of future investments or prior losses.

Entities generally expected to meet the requirements for deferral

The FASB expects the deferral to generally apply to a limited number of types of entities, including, but not limited to, mutual funds, hedge funds, private equity funds, venture capital funds, and certain mortgage REITs. The FASB recognizes that there are investments funds that are (1) not subject to U.S. GAAP or (2) are not included in the scope of ASC 946 but have the same characteristics as entities within the scope of ASC 946. For example, certain real estate investment trusts (REITs) may meet the conditions for the deferral even though they are not subject to ASC 946.

The deferral applies to an entity regardless of the magnitude of the reporting entity’s investment in the entity provided that all the conditions for the deferral are met.

Application of the VIE model as amended by ASU 2009-17 is also deferred for reporting entities with interests in money market funds that 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 as discussed below.

Entities not expected to meet the requirements for deferral

The deferral does not apply to securitization entities, asset-backed financing entities or entities formerly classified as qualifying special-purpose entities, even if practice considers those entities to have the characteristics similar to that of an investment company as defined in ASC 946 or for which it is industry practice to apply the guidance in ASC 946. Some examples of entities that do not meet the conditions for deferral include structured investment vehicles, commercial paper conduits, credit card securitization structures, residential or commercial mortgage-backed entities, and government sponsored mortgage entities.

Entities with multiple levels of subordinated investors for which the primary purpose is to provide credit enhancement to the senior interest holders do not qualify for the deferral. These may include certain collateralized debt obligations and collateralized loan obligations as these types of entities are typically considered to be asset-backed financing entities and not investment companies that meet the conditions for the deferral.

ASU 2010-10 states that entities with characteristics like those examples included in ASC 810-10-55-93 will not meet the conditions for the deferral.

Money market mutual funds

In addition to the deferral requirements discussed above, ASU 2010-10 also includes a separate deferral for a reporting enterprise’s interest in a fund that is required to comply with or operates 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. Judgment will be required to determine whether unregistered money market funds qualify for the deferral.
Money market funds generally invest in short-term government securities, certificates of deposit, and commercial paper and pay dividends that generally reflect short-term interest rates. Although credit losses in a money market fund could occur, these funds are typically required to be managed in a manner to minimize credit losses. Money market funds recognize their investments at amortized cost and maintain a constant net asset value (NAV) (typically $1.00) per share by adjusting the returns to their investors as general interest rates fluctuate.

Some believe that a money market manager’s fees represent a variable interest in the money market fund as a result of implicit or explicit guarantees to fund credit losses when the NAV decreases to a value less than $1.00 (often referred to as “breaking the buck”). In other words, some believe that historical funding provided by an asset manager implies that investors would be protected, at least in part, by the asset manager, even in situations in which the asset manager has no contractual obligation to provide future funding. Such an interpretation could result in the money market manager concluding that consolidation of the fund is required under ASU 2009-17. However, the FASB decided not to conclude on whether it agreed or disagreed with these views until the broader joint consolidation project with the IASB is completed.

Based on the restrictive requirements under which money market funds operate, and the required credit quality of the assets they are permitted to hold, the FASB believes that the VIE model as amended by ASU 2009-17 should not result in reporting entities having to consolidate money market funds. Therefore, ASU 2010-10 provides for a deferral of the implementation of the VIE model as amended by ASU 2009-17 for money market funds until the FASB’s joint project with the IASB is completed. The FASB made the deferral explicit, because some may have concluded that money market funds are not subject to the broader deferral described above given the view that many money market managers generally provide either implicit or explicit guarantees to money market funds.

Application of the VIE model as amended by ASU 2009-17 to a money market fund is unconditionally deferred, even if its investment managers or others provide support arrangements or guarantees. Any such support arrangement or guarantee (implicit or explicit) would be subject to the pre-amended VIE model consolidation analysis (formerly FIN 46(R)) as such funds would continue to be subject to the consolidation guidance prior to the VIE model as amended by ASU 2009-17.

**Disclosures**

The amendments in ASU 2010-10 do not defer the disclosure requirements of the VIE model as amended by ASU 2009-17. Accordingly, public and nonpublic companies will be required to provide the disclosures required by ASC 810-10-50-1 through 50-19 for all variable interests in variable interest entities, including variable interest entities that qualify for the deferral and were variable interest entities prior to the VIE model as amended by ASU 2009-17. A reporting entity is not required to provide these disclosures if an entity qualifies for the deferral under ASU 2010-10 and was not a variable interest entity prior to the VIE model as amended by ASU 2009-17.
Effective date and transition

The effective date for the deferral is the same as the effective date of the VIE model as amended by ASU 2009-17 which is as of the beginning of the reporting entity’s first annual reporting period that begins after November 15, 2009, and for interim periods within that first annual reporting period. If an entity meets the conditions for the deferral, the reporting entity should continue to apply the pre-amended VIE model in ASC 810-10 (i.e., FIN 46(R) prior to its amendment) or other applicable consolidation guidance, such as ASC 810-20 (formerly EITF 04-5), when evaluating the entity for consolidation. Refer to the 2007 edition of PwC’s Guide to Accounting for Variable Interest Entities which includes the guidance under FIN 46(R) prior to its amendment.

2.4 Questions and interpretive responses

Not-for-profit organizations

Question 2-1
Assume a for-profit entity (FP X) was involved with the design of a NFP entity (NFP A) that was established to do business with another NFP entity (NFP B) (i.e., state or local government) because NFP B was prohibited from doing business with FP X. Concurrently, all of NFP A’s activities are outsourced to FP X. May FP X apply the NFP scope exception to NFP A?

PwC response
Yes, we believe that the FP X could apply the NFP scope exception since NFP A was established as a NFP for a legitimate reason (legal prohibitions) and not to circumvent the VIE model. We understand that the SEC would share this view and has applied the NFP scope exception literally.

Employers that offer employee benefit plans

Question 2-2
Are non-leveraged ESOPs included in the scope of the VIE model, potentially requiring consolidation by the sponsor entity?

PwC response
No, non-leveraged ESOP plans are defined contribution plans and similar in important respects to pension arrangements covered by ASC 715, Compensation—Retirement Benefits (ASC 715). As a result, for employers, we believe non-leveraged ESOPs are excluded from the scope of the VIE model by the employee benefit plan scope exception described in VE 2.2.3.
QSPEs

Question 2-3
Do investors in a QSPE need to apply the guidance in the VIE model or are they scoped out?

PwC response
Yes, investors in a QSPE need to consider the VIE model since the scope exception previously available has been eliminated under the VIE model. The QSPE concept was introduced by the FASB to permit derecognition of transferred financial assets in securitization, provided that the securitization vehicle was considered a passive entity that met certain conditions. Those conditions included the requirement that the entity only hold passive financial assets and that its activities be significantly limited and entirely specified in the legal documents establishing the entity or creating beneficial interests. However in practice these conditions proved difficult to achieve because few assets were truly passive such that little or no-decision making is required. Consequently, the FASB decided to eliminate the QSPE concept from the accounting guidance.

Separate accounts of life insurance entities

Question 2-4
Does the separate account scope exception described in VE 2.2.5 include the general account of a life insurance entity (as described in the AICPA’s Audit and Accounting Guide, Life and Health Insurance Entities)?

PwC response
No, an insurance company must consider the guidance in the VIE model to determine whether the investments made by the general account are variable interests in a VIE that would necessitate consolidation or disclosure pursuant to the VIE model.

Governmental organizations

Question 2-5
An entity (the “Entity”) was formed through a competitive bid process to issue revenue bonds in order to finance the construction of a power plant (the “facility”). Although the Entity will legally own the facility, the facility was constructed for the sole benefit of a governmental entity (i.e., an entity that meets the definition per AICPA Audit and Accounting Guide, Audits of State and Local Governments). The owners of the Entity selected to issue revenue bonds are in the business of managing power plants. The facility was constructed on government owned land, and that land was leased to the Entity for the estimated life of the facility. At the end of the land lease term the title to the facility will automatically transfer to the governmental entity. At the inception of the land lease, the governmental entity simultaneously entered into an arrangement with the Entity that required the governmental
organization to purchase 100 percent of the output of the facility, i.e., electricity, on a long term basis. The governmental entity also had a fair value purchase option that allowed it to purchase the facility at any time during the lease term. As part of a competitive bidding process, Company X, a party that is not related to the Entity or to the governmental entity, entered into an arrangement with the Entity to guarantee the revenue bonds.

Company X is evaluating whether or not the Entity is in the scope of the VIE model because of the application of ASC 810-10-15-12(e). If the Entity is in the scope of the VIE model, then Company X would need to (1) determine if it holds a variable interest in the Entity (through its guarantee), (2) whether the Entity is a VIE, and if the Entity is a VIE (3) whether Company X should consolidate the Entity.

ASC 810-10-15-12(e) states that 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 (1) is not a governmental organization and (2) is used by the reporting entity in a manner similar to a variable interest entity in an effort to circumvent the provisions of the VIE model.

What factors should be considered when assessing the governmental organization scope exception?

**PwC response**

The first step in determining whether the Entity is eligible for the governmental organization scope exception is to determine whether the Entity meets the definition of a governmental organization. Guidance for making that determination is found in Federal Accounting Standards Advisory Board (FASAB), the Governmental Accounting Standards Board (GASB) standards and in paragraphs 1.01 and 1.02 of the AICPA Audit and Accounting Guide, Audits of State and Local Governments, and not in accounting standards issued by the FASB. If the Entity is a governmental organization, then it is excluded from the scope of the VIE model.

In this fact pattern, it is assumed that the Entity does not meet the definition of a governmental organization. Therefore, Company X must also consider whether the Entity is in substance a financing entity established by a governmental organization. This analysis is subjective and requires an understanding of all the facts and circumstances. While the Entity was formed to finance the construction of a power plant to be used by a governmental organization, it may not be clear whether the Entity was formed by a governmental organization. Listed below are some factors that should be considered when making this determination:

- What was the nature of the government’s involvement in establishing the Entity?
- What was the level of the government’s involvement with the selection of the board members of the Entity?
- Does the government have the right to unilaterally dissolve the Entity?
- What percent of the activities of the Entity are on behalf of the government?
□ What are the terms of the contract between the government and the Entity?

□ Do the assets revert back to the government at the end of the contract term?

□ Did the government provide any guarantees?

(Note: This list is not all inclusive.)

In addition, Company X is required to determine if the Entity was set up to circumvent the VIE model. When making this assessment, Company X should consider the intent and purpose of the Entity and whether Company X was involved in the design of the Entity for the purpose of obtaining off-balance sheet treatment for its relationship with the Entity.

In this fact pattern, the Entity is determined to be a financing entity established by a governmental organization and therefore not included in the scope of the VIE model (i.e., Company X does not have to determine if the Entity is a VIE). The basis for this conclusion is predicated on the following: the Entity was established to finance and construct a power plant for the governmental entity, the governmental entity was integral in the design of the Entity, the experience of the owners of the Entity, and the creation of lease agreements, power purchase agreements, and the purchase option. Therefore, even though the Entity does not meet the GASB or FASAB definition of a governmental organization, the facts and circumstances support that the Entity was a financing entity established by the governmental entity for the purpose of constructing a plant that the governmental entity would take 100 percent of the output and ultimately the governmental entity would own the Entity’s assets (either through the exercise of the purchase option or because the assets would revert back to the governmental entity at the end of the lease term).

Additionally, Company X’s involvement with the Entity was not to circumvent the VIE model because the Entity was established with the intention of financing the facility for the governmental entity and Company X’s guarantee contract was obtained through a competitive bid process.
Chapter 3: Variable interests
Executive takeaway

☐ The VIE model introduced a new accounting term: variable interest. A holder of a variable interest in an entity is required to determine whether the entity is a VIE and, if so, whether it must consolidate the entity.

☐ Variable interests must be identified and evaluated under the VIE model, as they can impact whether an entity is a VIE and which party, if any, is the entity’s primary beneficiary.

☐ Variable interests can take many forms, including equity and debt investments, guarantees, derivatives, management contracts, service contracts, and leases.

☐ Variable interests can exist in implicit relationships, especially if related party relationships are involved.
3.1 The concept of a variable interest

A variable interest results from an economic arrangement that gives a reporting entity the right to the economic risks and/or rewards of the entity, or its “variability.” A variable interest is a contractual arrangement or other agreement that does not give rise to or create variability in the fair value of the entity’s net assets and operations. Rather, it absorbs or has rights to some or all of the variability that the entity was designed to create. ASC 810-10-20 defines the term variable interest as follows:

Excerpt from ASC 810-10-20

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 legal entity. Paragraphs 810-10-55-16 through 55-41 describe various types of variable interests and explain in general how they may affect the determination of the primary beneficiary of a VIE.

Excerpt from ASC 810-10-55-19

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 entity’s variable interests. The labeling of an item as an asset, liability, equity, or as a contractual arrangement does not determine whether that item is a variable interest. It is the role of the item—to absorb or receive the entity’s variability—that distinguishes a variable interest. That role, in turn, often depends on the design of the legal entity.

The following example demonstrates the theoretical concept of a variable interest:

EXAMPLE 3-1

An entity is formed, and its primary activities involve the manufacture and sale of furniture. The entity purchases supplies and/or services from vendors, employees, and other parties in order to run its activities and create value in the business. The entity’s equity investors capitalize the entity to ensure that it has a level of financing sufficient to achieve its business purpose. The entity’s assets and other contractual arrangements reflect the results of the entity’s activities (i.e., the value of the business). The equity investors share in the value of the business positively (i.e., when the activities generate a value that is greater than expected) or negatively (i.e., when the activities generate a value that is less than expected). In this simple example, there are no parties, other than the equity investors, that share in the variability of the fair value of the entity’s net assets.
Now let’s consider what would happen if the entity were to finance the acquisition of a new manufacturing facility through a subordinated loan from a third-party bank. The existence of the loan does not create variability in the value of the business, rather the new manufacturing facility does. The bank is exposed to the risks and uncertainties of the entity’s activities through its loan. The bank and the equity investors stand to lose or gain from changes in the value of the business, and thus they each have a variable interest in the entity. The equity investors are not the only parties with a variable interest because the bank also has a variable interest that stands to lose or gain depending upon the changes in the value of the business.

Most assets of an entity create variability in an entity. They create changing cash flows that drive the success or failure of the entity, and therefore drive the economic performance (variability) in the entity. Most forms of financing or capital (including guarantees of debt and the value of assets and some derivative instruments) absorb variability in an entity (or an asset). The return to the lender or capital provider depends on the success or failure of the assets or liabilities that create the variability. Only those arrangements that absorb the variability of the entity are considered variable interests under the VIE model.

### 3.2 The “by design” approach in determining an entity’s variability and variable interests

Diversity in practice developed in determining whether certain contracts were creators of variability or absorbers of variability (i.e., variable interests). Much of this diversity resulted from different interpretations as to whether certain derivatives (interest rate swaps and foreign currency derivatives) were variable interests (absorbers of variability) or creators of variability. In determining whether these contracts were variable interests, some believed that only those that absorbed the variability resulting from changes in the entity’s cash flows (cash flow variability) should be considered variable interests, while others believed that those that absorbed changes in the entity’s fair value (fair value variability) should be considered variable interests. For example, assume that a VIE’s sole asset is a fixed rate U.S. treasury bond. Some would believe that this asset creates no variability because the U.S. Treasury is “risk free” from a credit perspective and interest rate payments are fixed (i.e., no cash flow variability). Others argued that the asset creates variability because the fair value of the bond fluctuates with changes in interest rates (i.e., fair value variability). These different viewpoints fostered diversity in practice with respect to the identification of the risks associated with an entity (i.e., the entity’s variability) and the party that absorbs those risks, which could potentially impact which party consolidates the VIE.

In April 2006, the FASB Staff responded to this diversity in practice by issuing guidance which indicates that an analysis of an entity’s design must be conducted to determine the variability that the entity was designed to create and distribute to its interest holders. It is important to note that the determination of the variability to be considered in applying the VIE model affects not only the determination of which interests are variable interests in the entity, but also whether the entity is considered a VIE, and which party, if any, is the primary beneficiary of the VIE.
The VIE model requires the use of significant judgment in determining what variability the entity was designed to create and distribute to its interest holders. The “by design” model is intended to provide a principle that allows for more consistent application. ASC 810-10-55-55 through 55-86 also include eight examples that illustrate how to apply these principles. We have included these examples in Appendix A.

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

**Excerpt from ASC 810-10-25-22**

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

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

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

**Excerpt from ASC 810-10-25-23**

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

The interest holders who absorb the risks that an entity was designed to pass along are the entity’s variable interest holders.

Step 1 of the “by design” model is fairly straightforward and its objective is to identify all of the risks of the entity. Examples of possible risks to which an entity may be subject to provided in the guidance are as follows:

**Excerpt from ASC 810-10-25-24**

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

a. Credit risk
b. Interest rate risk (including prepayment risk)

   c. Foreign currency exchange risk

   d. Commodity price risk

   e. Equity price risk

   f. Operations risk.

The purpose of Step 2 is to identify which of the risks identified in Step 1 create variability and are relevant to the assessment of an entity’s variability. Under the “by design” model, the relevant risks are those that the entity was designed to pass along to variable interest holders. Step 2 is further elaborated in the “by design” model as follows:

**Excerpt from ASC 810-10-25-25**

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

   a. The activities of the legal entity

   b. The terms of the contracts the legal entity has entered into

   c. The nature of the legal entity’s interests issued

   d. How the legal entity’s interests were negotiated with or marketed to potential investors

   e. Which parties participated significantly in the design or redesign of the legal entity.

**Excerpt from ASC 810-10-25-26**

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

In performing Step 2 of the “by design” model, a careful analysis of an entity’s governing documents, formation documents, marketing materials, and terms of all other contractual arrangements should be closely examined to determine the
variability that the entity was designed to create (i.e., which risks in Step 1 the entity was designed to create).

To further assist financial statement preparers in making this determination, the guidance highlights a number of strong indicators that suggest whether or not an interest is a variable interest (i.e., absorber of variability).

These indicators relate to the following:

- the terms of the interest;
- subordination of the interest;
- certain interest rate risk; and
- certain derivative instruments.

Each of these indicators are discussed further below.

### 3.2.1 Terms of the interests issued

Excerpt from ASC 810-10-25-31

Terms of Interests Issued

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

If the interest transfers risk and/or return of the entity’s assets or operations to the holder of the interest, this is a strong indicator that the interest is a variable interest (i.e., absorber of variability). The guidance provides an example of the application of this concept. In this example, an entity is established with funding in the form of a 5-year fixed rate note and equity so that it can acquire property. The property is leased under a 5-year lease to a lessee that has provided a residual value guarantee for the expected future value of the property at the end of 5 years. Because the residual value guarantee effectively transfers substantially all of the risks of the underlying property, there is a strong indication that the residual value guarantee absorbs the variability that the entity is designed to create.

The determination of whether an interest is a variable interest should not be based solely on the legal or accounting designation. Rather, the assessment should be based on whether the interest was designed to transfer risk to the interest holder, regardless of accounting or legal treatment. This is illustrated in the following examples.
EXAMPLE 3-2

Assume that a reporting entity transferred loan receivables in a true sale at law to a legal entity in return for cash, a beneficial interest in the legal entity, as well as a noncontingent fixed price call option on the financial assets transferred. Notwithstanding the true sale at law, the existence of the fixed price call resulted in the transfer failing sale accounting under ASC 860, Transfers and Servicing (ASC 860), and as a result, the transfer must be accounted for as a secured borrowing by both the transferor and the transferee (i.e., the transferor borrowed from the transferee). Given that, for accounting purposes, the receivables remain assets on the financial statements of the reporting entity, many previously believed that the retained risk (in the form of the beneficial interest in the legal entity) associated with the receivables would not constitute a variable interest in the legal entity. The FASB’s clarification that economic risks and rewards, not the accounting designation, should be considered when identifying variable interests could potentially change this determination. The accounting treatment is not relevant when assessing the risks that the entity was designed to pass along to the variable interest holders.

EXAMPLE 3-3

A reporting entity leases one asset from a legal entity that holds only two assets. The reporting entity has a fixed price purchase option to acquire the asset. The fair value of the leased asset is more than 50 percent of the fair value of the legal entity’s total assets. The lease was previously accounted for as a capital lease. The fixed price purchase option would be viewed as a variable interest in the entity. If the entity was considered a VIE (which would be very likely in this fact pattern), the reporting entity could be required to consolidate the VIE under the power and losses/benefits criteria (see VE 5.1). The results achieved by consolidating the entire entity (i.e., both assets and the liabilities of the VIE) could be substantially different from those achieved by applying prior capital lease accounting to only the leased asset.

3.2.2 Substantive subordination

The absorption of risks by substantive subordinated interests issued by the entity is a strong indicator of the variability that the entity is designed to create.

Excerpt from ASC 810-10-25-32

Subordination

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

When considering whether a subordinated interest is substantive, we believe that the following factors should be considered (this is not meant to be an all inclusive list):

- The overall waterfall (tranching) of the entity.
- Yields (interest rates) of the various interests issued.
- Amount and size of the subordinated interests to all other interests issued (e.g., to total capitalization of the entity).
- The nature of any credit ratings of the interests issued.
- The nature of the investors and how the instrument was marketed.

3.2.3 Certain interest rate risk

Significant questions have arisen in the past as to whether counterparties to market-based interest rate swaps and other absorbers of interest rate risk have variable interests or should consider the interest rate risk variability of the entity. Consideration of interest rate risk is clarified as follows:

Excerpt from ASC 810-10-25-33

Certain Interest Rate Risk

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

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

**EXAMPLE 3-4**

Consider a fact pattern in which an entity's only asset is a fixed-rate bond that is funded with variable-rate liabilities. The entity enters into a “receive-float, pay-fixed” interest rate swap, which allows the entity to pay a fixed interest rate in return for receiving a variable interest rate. This swap arrangement synthetically creates a variable-rate asset, which will absorb the interest rate exposure from the fixed-rate bond (unless the bond is expected to be held to maturity). We believe that in certain instances, interim fair-value variability can be ignored if it has no net cash-flow effect on the variable interest holders.

**EXAMPLE 3-5**

Consider an entity which is established to invest in a fixed-rate bond that is expected to be held to its maturity, which is funded with matching maturity fixed-rate debt. In this case, since there is no planned sale of the fixed-rate bond, the entity’s variability would not include variability caused by changes in interest rates.

Four additional examples that are helpful for determining how to consider interest rate risk variability have been included in the guidance (these are included as Case A, Case B, Case C and Case D in Appendix A).

3.2.4 **Certain derivative instruments**

Guidance for making the assessment of whether certain derivative contracts create or absorb variability is as follows:

**Excerpt from ASC 810-10-25-35**

Certain Derivative Instruments

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.

**Excerpt from ASC 810-10-25-36**

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

It is important to note that this guidance does not constitute a “scope exception” for derivatives, but rather simplifies the analysis for many common derivatives (e.g., certain market-based interest rate swaps and foreign currency contracts). A determination should be made as to whether the contract meets the characteristics of a derivative under ASC 815, Derivatives and Hedging (ASC 815). We believe that only contracts that meet the characteristics of a derivative are eligible for consideration under the “by design” guidance, regardless of whether or not the contract is afforded one or more of the scope exceptions in ASC 815-10.

Next, an evaluation of the contract’s underlying must be made to determine whether it is based on an observable market rate, price, index of prices or rates, or other market observable variable (including the occurrence or nonoccurrence of a specified market observable event). ASC 815-10-15-88 through 91 provides additional guidance on what constitutes an underlying of a derivative. Generally speaking, normal market contracts such as Treasury and LIBOR based interest rate swaps, foreign currency contracts, and commodity futures, would have market observable variables.

Finally, whether the derivative contract is senior in priority (i.e., senior in the waterfall) relative to other interest holders in the entity should be carefully considered. We believe that if the derivative is at least pari passu with the most senior interest issued by the entity, this condition would be met. Although, in practice, this condition is typically met for many market-based derivatives, this condition should still be carefully considered.

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

Refer to VE 3.3.7 for a further discussion of derivatives and embedded derivatives.
3.3 **Examples of variable interests**

Variable interests are not limited solely to equity investments. The excerpt below clarifies this point:

**Excerpt from ASC 810-10-20**

The investments or other interests that will absorb portions of a variable interest entity’s (VIE’s) expected losses or receive portions of the entity’s expected residual returns are called variable interests.

The following interests (the list is not all-inclusive) may be considered variable interests:

**Examples of potential variable interests**

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<th>Co-Marketing Arrangements</th>
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<td>Beneficial Interests</td>
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<td>Cost-Plus Arrangements</td>
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<td>Co-Manufacturing Arrangements</td>
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ASC 810-10-55-16 through 55-41 provide examples of some common contractual and ownership arrangements, and guidance on determining when these arrangements are variable interests. Examples of some of the variable interests included in the list above are discussed in further detail below. Keep in mind that the guidance provided below discusses the overall concepts of a variable interest and does not address how the economic risks and rewards are allocated to variable interest holders. This concept is discussed in VE 5.1.

**3.3.1 Equity investments**

The most obvious variable interests are equity investments. The equity investors provide capital to the entity and receive an ownership interest that exposes the investors to potential losses and potential returns of the entity. Therefore, they absorb the entity’s economic risks and rewards.
Excerpt from ASC 810-10-55-22

Equity investments in a VIE are variable interests to the extent they are at risk. (Equity investments at risk are described in 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.

The guidance in ASC 810-10-55-22 differentiates between an equity investment that is at risk and an equity investment that is not at risk. VE 4.1 provides guidance on determining when equity investment is at risk. Generally, the principles are based on whether or not the equity investor is exposed to losses, however there are some exceptions. The guidance for identifying an equity investment at risk is found in ASC 810-10-15-14a.(1)-(4).

ASC 810-10-55-22 clarifies an important point: just because an equity investment is not at risk does not necessarily mean that the investment is not a variable interest. An equity investment that is not at risk may nevertheless absorb expected losses and expected residual returns.

3.3.2 Debt instruments and beneficial interests

Reporting entities that provide financing to the entity are entitled to receive fixed or variable returns from the entity. Because the actual activities and the resulting fair value of an entity may affect the collectability of these returns, debt instruments absorb variability. As a result, virtually all debt instruments are variable interests.

Excerpt from ASC 810-10-55-23

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

As the level of priority with respect to returns of investments increases, the variability associated with those returns diminishes. Senior debt (e.g., investment grade debt) and senior beneficial interests with fixed interest rates or other fixed returns, are nevertheless interests that qualify as variable interests. The level of variability absorbed by senior interests may be reduced by the nature of subordinated interests and the relative credit quality of the entity.
Excerpt from ASC 810-10-55-24

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

3.3.3 Guarantees, put options, and similar obligations: Options purchased/exercisable by the entity/written by the reporting entity (see VE 3.3.5 for arrangements among variable interest holders)

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

Excerpt from ASC 810-10-55-25

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

In assessing guarantees to determine if they are variable interests, management should consider whether the guarantee is on specific assets or liabilities of the entity. The analysis can be different for a guarantee is on the entity’s assets compared to a guarantee on the entity’s liabilities.

If a guarantor has guaranteed the value of an asset of the entity, that guarantee is a variable interest in the entity only if the fair value of the guaranteed assets constitutes a majority (greater than 50 percent) of the fair value of the entity’s total assets. A guarantee of the value of an entity’s assets must first be evaluated to determine when it is a variable interest in the entire entity (as opposed to a variable interest in
specified assets). This concept, known as “variable interests in specified assets,” is described in further detail in VE 3.5.

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

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

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

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

3.3.4  **Guarantees, put options, and similar obligations: Options written by the entity (see VE 3.3.5 for arrangements among variable interest holders)**

Excerpt from ASC 810-10-55-26

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

If the entity is a writer of a put option, the contract transfers risk of loss to the entity and therefore creates variability for the entity. As a result, such contracts are not generally viewed as variable interests. The variability resulting from these arrangements must be considered in determining the entity’s economic risks and rewards. This is also consistent with the example in the “by design” guidance, where the FASB indicated that the credit default swap written by the entity is not a variable interest (see Case E in Appendix A).
If the entity writes a call option on its assets, the purchaser of this option has the right to buy an asset owned by the entity at a specified price. This contract is a variable interest in the asset because it absorbs the positive variability in the asset and may be a variable interest in the entity if the underlying asset is greater than 50 percent of the entity’s total assets.

**3.3.5 Guarantees, put options, and similar obligations: Options written/purchased among reporting entities**

In many circumstances, reporting entities write options that are purchased by another reporting entity or purchase options that are written by another reporting entity with respect to an entity’s assets/liabilities/equity. These options are not direct variable interests in the entity since they are not related to a specific contract with the entity but instead are contracts among reporting entities that have a variable interest in the entity. Even though the entity is not the counterparty to such options, however, such options do alter the cash flows with respect to the variable interests held by the reporting entities in the entity. For example, two Reporting Entities A and B hold variable interests in Entity X via their ownership of Entity X’s common stock. Reporting Entity A writes a put option on Reporting Entity B’s variable interest in Entity X (i.e., a put on Entity X’s common stock held by Reporting Entity A) whose strike price is fixed. Reporting Entity B holds this put option written by Reporting Entity A. While this put option may not be a separate variable interest in Entity X and does not change the variability of Entity X, it is part of the variable interest held by Reporting Entity A and Reporting Entity B because it alters the cash flows associated with the variable interest (i.e., Entity X’s common stock) held by Reporting Entity A and Reporting Entity B. Therefore, it is a variable interest and the option should be considered when analyzing who the primary beneficiary is, both from the point of view of the power criterion and losses/benefits criterion (see VE 5.1).

**3.3.6 Forward contracts and long term supply contracts**

The determination of whether forward contracts or long-term supply agreements are variable interests is complex and involves a careful consideration of the design of the entity. The FASB has provided little guidance on this determination.

**Excerpt from ASC 810-10**

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

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.

Forward contracts include contracts that meet the characteristics of a derivative under ASC 815-10 as well as long-term contracts such as purchase or supply contracts relating to plant output, raw materials, or other goods.

The contract should be evaluated to determine whether it contains an operating lease (considering applicable lease accounting guidance in ASC 840, Leases (ASC 840)). If the contract contains a lease, then refer to VE 3.3.11 for a further discussion of evaluating leases to determine if they are variable interests. The non-lease elements should also be analyzed to determine if they are variable interests.

If the contract does not contain an operating lease, the contract should be evaluated to determine whether it constitutes a derivative. If the forward contract meets the characteristics of a derivative under ASC 815-10, the contract should be evaluated under the derivative strong indicator in the “by design” model (see VE 3.2.4).

For those forward contracts and supply arrangements which are not determined to be creators of variability, a careful analysis of the terms of the contract and the design of the entity should be considered. The pricing of a contract (e.g., fixed price or fixed formula, cost plus, etc.) might affect the determination of whether the contract is a variable interest.

ASC 810-10-55-81 through 55-86 (see Appendix A) illustrates an example of how a forward purchase contract (i.e., a contract to purchase assets in the future at a fixed price) may be evaluated when considering whether the contract creates or absorbs variability. However, we believe that forward contracts are and will continue to be some of the most difficult interests to evaluate under the VIE model. Whether or not fixed price forward contracts absorb or create variability in an entity will often depend on whether there are significant other risks in the entity, other than the volatility in the pricing of the assets in a forward contract.

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

A question sometimes arises as to when an asset purchase contract is a variable interest. In certain cases, it may be viewed similarly to a traditional fixed price forward contract and, therefore, be considered a variable interest.

Note that if a forward contract relates to specified assets that comprise less than 50 percent of the fair value of the entity’s total assets, the contract would not be a variable interest in the entity (see VE 3.5).
3.3.7 *Other derivative instruments*

**Excerpt from ASC 810-10-55**

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

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

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

The determination of whether a derivative contract is a variable interest can be difficult and the following factors should be considered:

- Entity's activities and design.
- Role of the derivative (hedging/speculative purposes).

As mentioned previously, derivatives should be carefully evaluated (see VE 3.2.4 for further discussion).

In general, an embedded derivative that is not clearly and closely related to its asset or liability host should be evaluated to determine if it is a variable interest.

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

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

In these cases, the economic characteristics of the embedded derivatives are clearly and closely related to the debt instrument. However, in cases where the instruments have significant leverage or are based on factors that are not economically related to the debt instrument, each feature should be examined to determine whether it is a...
Variable interest. This would occur in situations where the debt includes a derivative that is indexed to one of the following:

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

### 3.3.8 Assets of the entity

**Excerpt from ASC 810-10-55-32**

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

Examples of assets that may be variable interests are derivatives, purchased guarantees, and similar contracts. In addition, an asset may have an embedded derivative feature that might be considered a variable interest (refer to VE 3.3.7).

### 3.3.9 Decision maker or service provider fees

If all of the following characteristics are present, the service provider/decision maker fee is not a variable interest.

**Excerpt from ASC 810-10-55-37**

Fees paid to an entity’s decision maker(s) or service provider(s) are not variable interests if all of the conditions below are met:

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

b. 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, such as trade payables.

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 a 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. The total amount of anticipated fees are insignificant relative to the total amount of the VIE’s anticipated economic performance.
f. The anticipated fees are expected to absorb an insignificant amount of the variability associated with the VIE’s anticipated economic performance.

Excerpt from ASC 810-10-55-37A

For purposes of evaluating the conditions in the preceding paragraph, the quantitative approach described in the definitions of the 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. In addition, for purposes of evaluating the conditions in 810-10-55-37, any interest in the entity that is held by a related party of the entity’s decision maker(s) or service provider(s) should be treated as though it is the decision maker’s or service provider’s own interest. For that purpose, a related party includes any party identified in paragraph 810-10-25-43 other than:

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.

Although the conditions appear straightforward, the analysis is complex. We will address each of these six conditions in more detail below.

3.3.9.1 Condition 1: Fee commensurate with the level of effort required

We believe that the purpose of this condition is to identify arrangements that clearly provide a service provider with a significant off market fee element or that is designed in a manner such that the fee determined or earned is inconsistent with the service provider’s role. Ultimately, the facts and circumstances will drive the conclusion regarding whether the service provider contract meets this condition.

3.3.9.2 Condition 2: Seniority of service provider fees

If substantially all of the service-provider’s fee is not at or above the same level of seniority as the entity’s other operating liabilities that arise in the normal course of business, the service contract is a variable interest.

The guidance lacks clarity as to whether or not the evaluation of seniority of the fee should be based on priority in liquidation (e.g., bankruptcy) or based on how the fee is determined (i.e., how calculated and whether it is based on earnings of the entity after consideration of other operating liabilities). It is important to note that the FASB included such a requirement in order to identify those service provider arrangements whose fees may not accrue in a manner that is similar to other service providers. For example, consider a situation where a performance fee is earned based on the net income of the entity. While a service provider who has earned such a fee may have a
senior claim in bankruptcy, it would seem that such a fee may not be typical of other service providers of the entity, as it is only “owed” if there is a residual profit to calculate it against. However, we believe that preparers could interpret that level of seniority as only referring to rights in liquidation, or view it more broadly based on how the fee is determined, provided that either interpretation is consistently applied. Note that if an accounting policy decision is made to interpret seniority based upon the contracts’ standing in liquidation, a careful evaluation of how the service contract is paid in liquidation should be made. Preparers may require the assistance of legal counsel in making this evaluation.

Additionally, the new VIE model does not provide guidance to help assess “substantially all.” While the guidance allows some element of the fee to not be considered as “senior,” it neither discusses a bright line, nor how to measure such a threshold. Some of the factors that could be considered in interpreting “substantially all” are as follows:

- Substantially all is intended to be a very high threshold. While we do not believe that there are any bright lines in interpreting such threshold, “substantially all” has been interpreted in other areas of GAAP to mean greater than 90%.

- The design of the fee arrangement and the role of the service provider may provide insights into why there is a fee element which could be earned that is not at least pari passu to other operating liabilities.

- A critical assessment of the underlying fee economics. For example a qualitative understanding of both of the following may aid in performing this assessment:
  - Expectations regarding the anticipated portion of both the senior fee element and the non-senior fee element.
  - The potential variability of the senior fee element and the non-senior fee element.

### 3.3.9.3 Condition 3: Service provider and related parties do not hold other variable interests in the VIE

A service provider fee is considered a variable interest if the service provider or its related parties have another variable interest in the VIE that absorbs more than an insignificant amount of the entity’s variability. We understand from our discussions with the FASB that it believes that probability should be one of the factors considered in assessing the requirements of Condition 3.

With respect to this condition, the term “related parties” denotes all related parties and de facto agents as defined in the VIE model except that employees and employee benefits plans of the service provider are excluded unless the employees and employee benefit plans are used in an effort to circumvent the provisions of the standard.

Companies should identify and consider all contractual arrangements with an entity in the aggregate (including, for example, equity investments, debt investments, lines
of credit, liquidity arrangements, letters of credit, derivatives, financial guarantees, etc.).

Judgment will be required to assess whether another interest or interests 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. While the FASB has included the concept of expected losses and expected residual returns, they did not intend for this requirement to be demonstrated by performing a detailed expected loss analysis. Rather, the FASB expects preparers to exercise judgment in performing a qualitative assessment of the economics provided by the service provider’s other interests.

Additionally, “more than an insignificant amount” has not been defined and is intended to mean the same as “significant.” However, in assessing “more than an insignificant amount,” it is clear that the FASB does not expect it to be a bright line analysis. In assessing this threshold, the FASB’s objective of identifying arrangements that are fiduciary in nature should be considered. We believe that the interpretation of the “more than an insignificant amount” is a fairly low threshold and if the reporting entity determines it absorbs more than an insignificant amount with respect to a variable interest, then it will likely also meet the losses/benefits criterion (see VE 5.1.3). We also believe that a qualitative assessment of the additional variable interest(s) held by the service provider (and its related parties) utilizing the following factors may assist in that determination:

- The size of the variable interest to the overall capitalization of the entity.
- The commercial reasons as to why such variable interest is held by the service provider. For example, consider situations in which investments by the service provider were made to support marketing of investments into the entity. In this case, it may indicate that the service provider made such investment to signal to others that the service provider is willing to put its own interests at risk. This may indicate that the service provider is not acting as a fiduciary as it made the investment to demonstrate to the other investors that it has “skin in the game.”
- The relative risks and rewards of the variable interests held by the reporting entity to the overall economics of the structure.
- The seniority of the other variable interests. We believe that as the variable interest’s seniority becomes lower (i.e., more subordinate to other interests) the threshold at which the interest is “more than insignificant” becomes lower.

The FASB decided to exclude interests held by employees from this evaluation in recognition of the fact that employees of investment managers often invest in their employer’s funds. The FASB did not believe this should prevent the fees from qualifying for the exception under condition 3. Further, the FASB also decided to exclude interests held by employee benefit plans because it believed that the substantive regulatory and fiduciary requirements governing employee benefit plans are sufficient to permit this exclusion.
3.3.9.4 **Condition 4: Service arrangement includes customary terms, conditions or amounts**

Unique and uncustomary provisions indicate that the service provider/decision maker may be functioning in a manner that is inconsistent with the behavior of a provider of customary fiduciary-type services to the entity. Corroborating whether the provisions are customary may require a reporting entity to evaluate similar contracts in similar industries.

3.3.9.5 **Conditions 5 and 6: Total anticipated fees and their variability are insignificant relative to the VIE’s anticipated economic performance and the VIE’s variability**

The FASB included these two conditions—one based on anticipated performance and the other based on the variability in performance—to assist in the identification of whether the fees of a service contract may indicate that the service provider is acting as a principal rather than an agent. The FASB believes that if the fee is more than insignificant to the entity (i.e., the fee is significant), then it would indicate that the service provider has sufficient economic benefit to conclude that it is not solely acting as a fiduciary. This is despite contractual limitations that may be provided in the contract to act as a fiduciary (e.g., contractual terms that require the service provider to act as a fiduciary or to provide professional due care in carrying out its role as a service provider).

The FASB does not believe that more than insignificant is a bright line analysis, but rather should be assessed on a qualitative basis. Additionally, when assessing service contracts under these two conditions, it is not expected that preparers would perform an analysis that is consistent with the expected losses and expected residual return analyses that may have been typically performed under the prior VIE model. In performing the evaluation of these two conditions, the following considerations may be useful:

- The anticipated economic performance of the entity and the service contract over the anticipated life of the entity should be considered based on its design.
- In considering the variability of the economic performance of the entity and the service contract, a careful consideration should be made with respect to the key drivers of variability of the entity (based upon the analysis described in VE 3.2).
- The performance elements of the fee may have certain “hurdle” rates whereby the fee will only be earned if such a rate is met. An evaluation of the likelihood of meeting that rate could be useful in the analysis as well as the size of the fee relative to the performance of the entity (if the hurdle is met).

We understand from our discussions with the FASB that it believes that probability should be considered in considering the anticipated economic performance of the entity and its variability.
3.3.9.6 **Reconsideration of decision maker and service provider arrangements**

VE 4.3 describes reconsideration events to re-evaluate whether or not an entity is, in fact, a VIE under the VIE model. VE 5.1 discusses that the VIE model requires an ongoing reconsideration of whether a reporting entity is the primary beneficiary of a VIE due to changes in facts and circumstances. The VIE model does not specify reconsideration of whether or not a decision maker or service provider arrangement is a variable interest should be based on reconsideration events or should be carried out on a continuous basis. We believe that reconsideration of whether or not a decision maker or service provider arrangement is a variable interest is a policy choice by the reporting entity (see Question 3.2 in this Chapter).

3.3.9.7 **ASU 2010-10 and its potential impact on decision maker and service provider arrangements**

On February 25, 2010, the FASB issued Accounting Standards Update 2010-10 (ASU 2010-10) to defer the VIE model as amended by ASU 2009-17 for certain investment entities that have the attributes of entities subject to ASC 946. Included in ASU 2010-10 were two clarifications to the variable interest evaluation of service provider and decision maker arrangements. The ASU clarifies that related parties should be considered when evaluating each of the criteria (i.e., each of the conditions described above) for determining if a decision maker(s) or service provider(s) fee represents a variable interest, with an exclusion for an employee of the service provider or an employee benefit plan as long as the exception is not used in an effort to circumvent the provisions of the VIE model. Based upon the language used in the guidance, some users had inferred that related parties had to only be considered when evaluating Condition 3.

In addition, ASU 2010-10 clarifies the FASB’s view that when evaluating whether a decision maker or service provider holds other interests in the variable interest entity that would absorb more than an insignificant amount of the expected losses or receive more than an insignificant amount of the expected residual returns (i.e., Condition 3), a formal quantitative assessment (e.g., expected loss calculation) is not required and should not be the sole determinant as to whether such rights and obligations exist.

3.3.10 **License, royalties, and other similar arrangements**

Generally, these contracts are linked to an entity’s performance indicators (e.g., revenue, EBITDA, etc). As a result, such contracts typically absorb variability in the entity in that they have variable payments that entitle the counterparty to changes in the fair value of the entity’s net assets. For example, if a reporting entity earns royalty from a technology license that it licensed to the entity based on the entity’s sales, then such an arrangement is a variable interest that absorbs variability in the entity. However, if the entity earns royalty from a technology license that it licensed to the reporting entity based on the reporting entity’s sales, then such an arrangement is typically a variable interest to the entity that absorbs variability in the reporting entity.
3.3.11 Leases

Excerpt from ASC 810-10-55-39

Receivables under an operating lease are assets of the lessor entity and provide returns to the lessor entity with respect to the leased property during that portion of the asset’s life that is covered by the lease. Most operating leases do not absorb variability in the fair value of a VIE’s net assets because they are a component of that variability.

Guarantees of the residual values of leased assets (or similar arrangements related to leased assets) and options to acquire leased assets at the end of the lease terms at specified prices may be variable interests in the lessor entity if they meet the conditions described in paragraphs 810-10-25-55 through 25-56. Alternatively, such arrangements may be variable interests in portions of a VIE as described in paragraph 810-10-25-57. The guidance in paragraphs 810-10-55-23 through 55-24 related to debt instruments applies to creditors of lessor entities.

Entity is lessor (entity leases assets to others)

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

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

- Lessee purchase options.
- Lessee residual value guarantees.
- Lessee renewal options.

Lessee purchase options

A fixed-price or formula-based purchase option is a variable interest in the asset because it provides the holder of that option with the potential to purchase the asset at a price that is less than fair market value. Effectively, if the purchase option were exercised, the equity investors would not receive all of the asset’s expected residual returns. If the purchase option were on assets that comprise less than 50 percent of the fair value of the entity’s total assets, the purchase option would not be a variable interest in the entity as a whole. Rather, it would be a variable interest in specified assets (refer to discussion in VE 3.5 regarding variable interests in specified assets).

Lessee residual value guarantees

In many leasing arrangements, the lessee provides a residual value guarantee on the leased asset. A residual value guarantee is a variable interest because it protects the equity investors from negative variability in the fair value of the leased asset (i.e., the equity investors do not have the obligation to absorb all of the entity’s economic...
risks). If the residual value guarantee covers only specified assets that comprise less than 50 percent of the fair value of the entity’s total assets, the residual value guarantee would not be a variable interest in the entity; rather it would be a variable interest in specified assets (refer to discussion in VE 3.5 regarding variable interests in specified assets).

**Lessee renewal options**

We also believe that renewal options in leases with strike prices at an amount other than fair value may be variable interests. If a lease includes one or more renewal options, and those renewal options are not included in the lease term, as defined in ASC 840-10-20, the renewal option is a variable interest because it provides the lessee with the right to use the assets for a period beyond the original lease term. Thus, the renewal option captures a portion of the residual value of the asset. However, if the renewal option was solely for specified assets that represent less than 50 percent of the fair value of the entity’s total assets, the renewal option would not be a variable interest in the entity. Rather, it would be a variable interest in specified assets (refer to VE 3.5 for a discussion of variable interests in specified assets).

See VE 5 for primary beneficiary analysis, particularly with respect to certain single asset owning special purpose entities (lessor entities).

**Entity is the lessee**

When the entity is the lessee (in both operating and capital leases), it should be treated much like a debt instrument is treated since these are, in essence, financing arrangements.

### 3.4 **“Implied” variable interests**

In applying the VIE model, in addition to assessing the economic arrangements in the form of an explicit contractual arrangement with an entity, “implied” relationships should also be considered. Implicit guarantees of an entity’s assets are variable interests if they protect holders of other interests from suffering losses. Such implicit guarantees are implied variable interests that should be considered in determining whether an entity is a variable interest entity and in identifying which party, if any, is the entity’s primary beneficiary. In essence, an implicit variable interest should be treated no differently than an explicit variable interest. Implicit variable interests often manifest themselves in fact patterns where two related parties may be involved in an entity, but only one has an explicit variable interest.

The VIE model provides guidance for determining when activities around the entity would cause a reporting entity to have a variable interest. An implicit variable interest is described as an interest that absorbs or receives the variability of an entity indirectly, rather than through contractual interests in the entity.
25-52: The identification of explicit variable interests involves determining which contractual, ownership, or other pecuniary interests in a legal entity directly absorb or receive the variability of the legal entity. An implicit variable interest acts the same as an explicit variable interest except it involves the absorbing and (or) receiving of variability indirectly from the legal entity, rather than directly from the legal entity. Therefore, the identification of an implicit variable interest involves determining whether an entity may be indirectly absorbing or receiving the variability of the legal entity. The determination of whether an implicit variable interest exists is a matter of judgment that depends on the relevant facts and circumstances. For example, an implicit variable interest may exist if the reporting entity can be required to protect a variable interest holder in a VIE from absorbing losses incurred by the legal entity. See Example 4 (paragraph 810-10-55-87) for an illustration of this guidance.

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.

The guidance does not, however, provide a bright line for determining when an implicit variable interest exists. Instead, it indicates that such determinations are a matter of judgment and will depend on the relevant facts and circumstances.

The guidance on implicit variable interests is important for a number of reasons. In particular, it helps to ensure that the objective in the VIE model is met regarding the consolidation of variable interest entities by a company that (a) has the power to make decisions that significantly affect the economic performance of the entity and (b) absorbs losses or has the right to receive benefits from the VIE that could potentially be significant to the VIE. It also prevents reporting entities from circumventing the provisions of the VIE model by absorbing variability indirectly, such as through an arrangement with another interest holder, rather than directly from the entity.

Implicit variable interests may arise from transactions with related parties, as well as unrelated parties. The VIE model provides one clear example: Reporting Entity A leases a facility from Entity B, which is owned by one of Reporting Entity A’s two owners and has the facility as its only asset. The lease, which qualifies as an operating lease, contains no explicit guarantees or purchase options, and is therefore not considered a variable interest. Reporting Entity A should consider whether it holds an implicit variable interest in Entity B as a result of its leasing arrangement and its relationship with the owner of Entity B. All relevant facts and circumstances should be considered to determine whether Reporting Entity A may effectively protect all or a portion of the owner’s investment or would be expected to make funds available (this would indicate that an implicit variable interest exists). Those facts and circumstances
may include both impediments to protect and incentives to protect. The following table illustrates this concept:

<table>
<thead>
<tr>
<th>Impediments to protect</th>
<th>Incentives to protect</th>
</tr>
</thead>
<tbody>
<tr>
<td>□ Whether Reporting Entity A has the capacity to provide protection of Entity B</td>
<td>□ Whether Reporting Entity A is a related party, has other fiduciary responsibilities to Entity B, or is under common ownership</td>
</tr>
<tr>
<td>□ Whether Reporting Entity A has any debt covenants or other restrictions that would prevent it from protecting Entity B</td>
<td>□ The importance of the facility and the economic reality for Reporting Entity A to relocate</td>
</tr>
<tr>
<td>□ Whether there are regulatory or other constraints that could consider such actions as conflict of interest or illegal</td>
<td>□ Whether there may be any consequences to Reporting Entity A with Entity B defaulting on its debt</td>
</tr>
</tbody>
</table>

Another indicator is whether Reporting Entity A has, in the past, provided any guarantees or indemnified losses of Entity B.

It is important to note that implicit interests can also result from contractual arrangements with unrelated variable interest holders. A reporting entity may enter into contractual agreements with variable interest holders that effectively protect those holders from absorbing a significant amount of an entity’s variability. In these circumstances, the contractual agreements with the variable interest holders may be considered implicit interests in the variable interest entity, although there may be no direct contractual interest in the variable interest entity.

At a minimum, reporting entities should consider the following questions (which by no means constitute an all-inclusive list) when assessing whether an implied variable interest is held in an 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?

□ Did the arrangement reference specified assets of the entity?

We believe that all activities between variable interest holders, the entity, and entities involved with the entity must be considered in the application of the VIE model. A reporting entity should also consider the substance of the arrangement, including all economic and related-party relationships between the reporting entity and the entity.
in assessing whether the reporting entity might be exposed to the majority of the risks associated with the VIE. The need to determine the substance of such arrangements underscores the importance of understanding and assessing the terms for all significant contracts and arrangements.

### 3.5 Variable interests in specified assets

Some reporting entities may have a variable interest in certain assets of an entity, as opposed to a variable interest in the entity as a whole.

**Excerpt from ASC 810-10-25**

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

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

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

- The variable interest relates to specified assets that comprise less than a majority of the total value of the entity’s assets (on a fair-value basis).

- That holder of the variable interest does not have another variable interest in the entity as a whole (except interests that are insignificant or have little or no variability).

We believe that this guidance applies only to variable interests in specified assets. A guarantee on the repayment of debt which is dependent on the general credit of the
entity, regardless of how much debt the guarantee relates to, is a variable interest in the entity.

The following example illustrates the application of variable interest in specified assets of a VIE:

**EXAMPLE 3-6**

*Background:* Assume that an entity owns two assets: a building worth $5.2 million and equipment worth $4.8 million. The building is leased to Reporting Entity A under a long-term lease, and Reporting Entity A provides a residual value guarantee that the building will be worth $4.2 million at the end of the lease’s term. The equipment is leased to Reporting Entity B under a long-term lease, and Reporting Entity B provides a residual value guarantee that the equipment will be worth at least $3.0 million at the end of the lease’s term.

*Evaluation of residual value guarantee provided by reporting Entity A:* The residual value guarantee provided by Reporting Entity A is a variable interest in the entity, since the guarantee is on an asset that represents more than 50 percent of the total fair value of the entity’s assets (the fair value of the asset is 52 percent of the total fair value of assets).

*Evaluation of residual value guarantee provided by reporting Entity B:* The residual value guarantee provided by Reporting Entity B is not a variable interest in the entity since it is on an asset that represents less than 50 percent of the total fair value of the entity’s assets (the fair value of the asset is only 48 percent of the total assets). Expected losses covered by this residual value guarantee would not be considered as part of the expected losses of the overall entity.

It is important to note that the determination of whether the variable interest relates to the entity or a specified asset in the entity is based solely on the fair value of the asset compared to the fair value of the entity’s total assets, and not the level of protection provided to the asset or rights to upside on the asset. The reporting entity’s actual obligation related to the specified assets does not influence the evaluation. For example, a guarantee related to the value of assets that comprise 90 percent of the entity’s assets may be limited to 10 percent of the total loss in value of those assets. Although limited, that guarantee would constitute a variable interest in the entire entity and would likely result in the entity’s being considered a VIE because that guarantee protects the equity investors from first-dollar losses on their investments.

*How variable interests in specified assets affect the determination of the expected losses of the entity*

If a variable interest is determined to be a variable interest in specified assets and not a variable interest in the entity as a whole, the expected losses and expected residual returns related to those specified assets that are absorbed by such interests should be excluded from the calculation of the entity’s expected losses and expected residual returns. Effectively, this means that the entity’s expected losses and expected residual returns are calculated net of the effects of any variable interests in specified assets that
are not variable interests in the entity as a whole. If an interest is determined to be a variable interest in specified assets and not in the entity as a whole, it is viewed in essence as a creator of variability, not an absorber. If an interest in specified assets of an entity is a variable interest in the entity as a whole, the losses related to those specified assets absorbed by the variable interest are included in the entity's expected losses for the purposes of determining whether the entity is a VIE (refer to VE 4.2.1 for information on assessing the sufficiency of the equity investment). In this case, the entity's expected losses and expected residual returns are grossed up to the amounts that they would be absent the effects of the variable interest.

For example, if the guarantee in Example 3-6 above only provided protection up to the first $100,000 of losses on the equipment, expected losses of the entity would exclude the first $100,000 of losses in the value of the equipment, but include the amount in excess of $100,000 (i.e., losses not absorbed by the guarantee).

### 3.6 Silos: A VIE within a VIE

While only legal structures can be VIEs, the FASB was concerned that VIEs could be structured to separate the rights and obligations of different parties involved and therefore to avoid consolidation.

As a result, the FASB included the notion of a silo in the VIE model. A silo can be thought of as a VIE within a VIE, in which a party holds a variable interest in selected assets and liabilities of a VIE (i.e., a reporting entity consolidates a discrete portion of a VIE as if it were a separate legal entity).

**Excerpt from ASC 810-10-25-57**

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

To help with the identification of silos, the VIE model guidance states the following:

**Excerpt from ASC 810-10-25-58**

A specified asset (or group of assets) of a VIE and a related liability secured only by the specified asset or group shall not be treated as a separate VIE (as discussed in the preceding paragraph) if other parties have rights or obligations related to the specified asset or to residual cash flows from the specified asset. A separate VIE is deemed to exist for accounting purposes only if essentially all of the assets, liabilities, and equity of the deemed VIE are separate from the overall VIE and specifically identifiable. In other words, essentially none of the returns of the assets of the deemed VIE can be
used by the remaining VIE, and essentially none of the liabilities of the deemed VIE are payable from the assets of the remaining VIE.

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

- Specified assets, specified liabilities, and specified equity are separate from the overall entity.
- Specified assets, specified liabilities, and specified equity are clearly identifiable.
- Essentially none of (1) the returns from the separate assets are shared/used by holders of interests in the larger VIE and (2) the specified liabilities are not paid using assets of the larger VIE.
- There is a primary beneficiary of the silo.
- The entity as a whole is a VIE.

*How silos affect VIE analysis*

A silo can only exist within a VIE. If the silo is deconsolidated from the larger VIE, expected losses and expected residual returns of the silo would not be considered in the calculation of expected losses and expected residual returns of the larger legal entity. Therefore, in determining the expected losses and expected residual returns of the remaining VIE the following steps should be performed:

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

Performing these steps complicates the expected-loss considerations of the larger legal entity. However, silos only exist in a few limited cases (i.e., the conditions of being a silo are extremely restrictive and very difficult to meet). Therefore, most reporting entities will not need to perform this step.
### Question 3-1

Should significant unanticipated market changes and their impact on the performance of the entity require a reassessment of whether or not a decision maker or service provider arrangement is a variable interest under Conditions 3 (other interests that absorb more than an insignificant amount of the entity’s variability), 5 (anticipated fees are insignificant to the total entity’s anticipated economic performance) and 6 (anticipated fees are expected to absorb an insignificant amount of the variability associated with the entity’s anticipated economic performance)?

**PwC response**

The new guidance does not specify whether the reassessment of whether or not a decision maker or service provider contract is variable interest should be re-performed when the entity has a significant change in its anticipated performance. We believe that reporting entities can reassess on an ongoing basis whether or not a decision maker or service provider fee is a variable interest for such situations. If a reporting entity were to establish an accounting policy requiring such assessment, we would generally expect that only significant economic changes in the performance of the entity could change previous conclusions reached. For example, if a reporting entity has concluded that the service contract is no longer a variable interest because other interests held no longer absorb more than an insignificant amount of the entity’s variability (Condition 3), then the reporting entity must be comfortable that the likelihood of the interest attracting significant variability in the future is highly unexpected or anticipated. Additionally, it would be important to assess whether the substance of the entity’s role as a service provider has evolved as that of a fiduciary (or vice versa).

Additionally, we believe there can be specific events that occur that would require a re-evaluation, for example, a sale of another interest held by the reporting entity which would result in the service provider no longer holding another interest in the entity therefore allowing it to now meet Condition 3 (other interest that absorb a more than insignificant amount of the entity’s expected losses).

### Question 3-2

Do servicing arrangements that include “servicing advances” and “clean up calls” meet the “service arrangement includes customary terms, conditions or amounts” condition (i.e., Condition 4) to not be considered as a variable interest?

**PwC response**

Yes, we believe that servicing contracts that include the right to provide “servicing advances” and the right to exercise “clean up calls” are customary in many asset-backed securitization arrangements and would generally meet Condition 4 (i.e., the
“service arrangement includes customary terms, conditions or amounts” condition to not be considered as a variable interest).

**Implied variable interests**

**Question 3-3**

The chief executive officer (CEO) owns 100 percent of Lessor and holds 61 percent of the voting rights of Lessee. Lessor is a real estate company that principally leases office buildings to Lessee. Lessee is a publicly traded financial institution. Lessee is governed by an independent board of directors and is regulated by governmental banking agencies. Both the board of directors and the banking regulators govern related party transactions. All of the lease arrangements between the two companies are classified as operating leases under ASC 840. In addition, the lease terms are considered at market rates and terms. The leases do not have residual value guarantees or purchase options, and therefore are not explicit variable interests that Lessee has in Lessor. From Lessee’s perspective, are the lease agreements considered implied variable interests in Lessor?

**PwC response**

No, the facts do not support this conclusion. The independent board of directors that governs Lessee and the governmental banking regulatory oversight preclude the CEO from making any decisions regarding Lessee’s involvement with Lessor that would not be in the best interest of Lessee’s public shareholders.

The identification of an implicit or explicit variable interest may affect (1) the determination of whether the entity should be considered a VIE, (2) the calculation of expected losses and expected residual returns, and (3) the determination of the VIE’s primary beneficiary (or, alternatively, the determination that the VIE has no primary beneficiary). The determination of whether the Lessee is effectively or implicitly guaranteeing all or a portion of the CEO’s investment in the Lessor or the property subject to lease should take into consideration all of the relevant facts and circumstances, including the following:

- Does the lessee have an economic incentive to act as guarantor or to make funds available to the lessor, even though the lessee is not contractually required to do so?

- Has economic protection been historically provided?

In performing a consolidation analysis, clients and engagement teams should consider both the impediments and incentives. In this particular fact pattern, the impediments far outweigh the incentives.

An implicit guarantee may exist if there were incentives for Lessee to protect Lessor and there were no substantive barriers impeding the following:

- CEO’s decision making ability vis-à-vis Lessor in the setting of lease rates between Lessor and Lessee.
CEO’s ability to require Lessee to make payments to Lessor, above and beyond those contractually stipulated under the lease arrangements as reimbursement for losses that Lessor incurred by virtue of holding the leased assets.

In this fact pattern, however, the CEO’s decision making ability is thwarted by various impediments, including the independent audit committee, the board of directors, and the need to comply with governmental banking regulations. These barriers preclude Lessee from (1) entering into leases with above-market rents to protect the CEO’s interest in Lessor; (2) making payments other than rental payments required by the lease; (3) entering into lease agreements for space that is not needed; and (4) providing Lessor with additional cash to protect the CEO’s equity in the event that losses are incurred. Historically, Lessee has not leased property from Lessor at above-market terms or that it did not need.

**Call options**

**Question 3-4**

A venture is created, whereby Company A and Company B each contributes $50 million in cash in exchange for a 50% equity ownership. The venture’s board of directors consists of 4 directors. Company A and Company B each has equal representation on the board and decisions require a unanimous vote. Company A has an option to purchase Company B’s equity interest for $60 million two years from the venture’s inception date. Is the option to purchase Company B’s equity interest a variable interest at inception under ASC 810?

**PwC response**

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

We believe that if the strike price of the option is at “true” fair value, then such an option is not to be a variable interest since the option price fluctuates with the change in the fair value of the entity. Caution should be exercised with respect to fair value call options to ensure that the definition of fair value in the agreement is consistent with “true” fair value. Some agreements may define formulas for the strike price of the call option designed to mimic fair value or expectations of fair value (e.g., formulas based on trailing earnings before interest, depreciation and taxes). In many cases, these formulas may be close to fair value, but do not represent fair value.
Non-refundable deposits

Question 3-5
Company A (reporting entity) enters into a purchase and sale agreement with Company X (entity) under which Company A will buy from Company X and Company X will sell to Company A land and building. Company X’s sole asset is the land and building under the agreement. As part of the agreement, Company A is required to pay a non-refundable deposit to Company X. Company A also has the right to terminate the contract, subject to the loss of its deposit. Does Company A have a variable interest in Company X due to the purchase and sale agreement?

PwC response
Generally yes. This situation is common with land deposits for homebuilders but is equally relevant to many purchase and sale agreements for real estate.

A plain vanilla purchase and sale agreement for real estate that provides for conditions precedent to closing generally would not be considered a variable interest since it typically does not transfer to the buyer the usual risks and rewards of ownership, primarily as a result of the many substantive conditions that exist and that result in the purchase being contingent upon satisfaction of such conditions. Some relevant considerations include:

☐ Does the execution of the purchase and sale agreement transfer the risk of loss with respect to the property to the prospective buyer?

☐ Is sale contingent upon the existing lender’s consent to the transfer of the property and assumption of existing loan?

☐ Is seller required to comply with specific title and zoning requirements, specified violations that must be cured prior to closing, obtain estopper certificates, etc.?

☐ Is buyer allowed to terminate contract upon certain specified material events?

In the fact pattern in this example, the purchase and sale agreement of real estate requires Company A (buyer) to make a non-refundable deposit to Company X (seller) where Company X’s sole asset is the real estate subject to the agreement. The non-refundable deposit absorbs some of the Company X’s variability and transfers to the buyer some of the usual risks and rewards of ownership. Therefore, the purchase and sale agreement in this fact pattern is a variable interest that Company A holds in Company X.

In circumstances in which the selling entity has other assets (outside of the real estate subject to the purchase and sale agreement), a careful analysis under ASC 810-10-25-55 must be performed in order to determine whether or not it represents a variable interest in specified assets and therefore not a variable interest in the entity overall.
Question 3-6

Similar fact pattern as in Example 3-6 above except that Company A’s deposit is a conditionally refundable deposit. The purchase and sale agreement states that Company A is obligated to purchase the land and building only if (i) Company X gets the zoning for the property changed; or (ii) Company X obtains written consent from its lenders permitting Company A to assume existing non-recourse debt encumbering the property. There is a time limit on the resolution of the contingencies and if the contingencies are met, Company A must either purchase the land and building or forfeit the deposit. Does Company A have a variable interest in Company X due to the purchase and sale agreement? Should the purchase and sale agreement be re-evaluated if and when the contingencies are met?

PwC response

It depends on the nature of and status of the contingency. To determine whether or not a purchase and sale agreement is a variable interest, the agreement must be evaluated to determine whether or not it transfers to the buyer (reporting entity) the obligation to absorb some or all of the variability of the selling entity. For instance, if a purchaser’s rights to terminate an agreement to purchase real estate and receive a refund of its deposit are substantive, an acceptable view would be that such a contingently refundable deposit is not a variable interest, primarily because neither the seller nor the purchaser has control over these contingent events, and therefore, the deposit could be seen as a contingent forward contract.

The determination of whether the purchaser’s rights are substantive should be based on facts and circumstances. In the fact pattern under consideration, the buyer’s rights to terminate the contract and receive a refund of its deposit are substantive since the contingencies are not within the control of either the buyer or seller and involve some uncertainty relating to obtaining third party action. If the contingency were solely in control of the buyer or seller, such provisions may not be substantive and the arrangement should be evaluated as if the amount was non-refundable.

Furthermore, the resolution of whether the conditionally refundable deposit is a variable interest would need to be re-evaluated if a reconsideration event occurred ASC 810-10-35-4. For example, in the circumstances described above, if the contingencies were met (i.e., zoning approval obtained or lender approval received) and no remaining contingencies existed, a reconsideration event may have occurred. The deposit should then be viewed as a non-refundable deposit and re-evaluated per Example 3-6 above.
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Determining whether an entity is a VIE

Executive takeaway

- One of most critical steps in applying the VIE model is assessing whether or not an entity is a VIE. The overall objective is to identify those entities for which voting interests are not effective in determining whether the holder of the voting interests or another party has a controlling financial interest in the entity. The VIE model assumes that voting equity holders do not have traditional characteristics of control (and therefore that the entity is a VIE) if any of the following conditions exist:
  - The entity is thinly capitalized (i.e., the equity is not sufficient to fund the entity’s activities without additional subordinated financial support).
  - The equity holders as a group have one of the following four characteristics:
    - Lack the power to direct the activities that most significantly impact the entity’s economic performance.
    - Possess nonsubstantive voting rights.
    - Lack the obligation to absorb the entity’s expected losses.
    - Lack the right to receive the entity’s expected residual returns.
  - To determine whether the characteristics of a VIE are present, it is necessary to identify which investors and investments are considered at risk, as described in the VIE model.
  - The VIE model requires the reporting entity to determine whether an entity is a VIE at the time of its creation and/or design (or on the reporting entity’s first date of involvement with that entity) and to re-evaluate whether or not that entity is a VIE if certain events occur.
4.1 **First step: Identifying the holders of the equity investment at risk**

The definition of an *equity investment at risk* (or “equity at risk”) in the VIE model must be used to determine whether or not any of the characteristics of a VIE are present. Equity investments that are recorded in the equity section of the entity's GAAP financial statements are the starting point for this evaluation. However, just because an investment is labeled as “equity” in the entity’s financial statements does not necessarily mean that it is at risk. A careful analysis is necessary to ensure that an equity investment meets the conditions of being at risk. An equity investment at risk is defined as follows:

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

...For this purpose, the total equity investment at risk has all of the following characteristics:

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

Examples of equity instruments that do not qualify as equity at risk include the following:

- Equity that, due to its legal rights, does not participate significantly in income and losses of the entity. For example, nonparticipating, fixed-rate, preferred stock would not qualify, since it does not participate in the income of the entity.

- Equity provided to the equity investor in the form of fees, such as “sweat equity” or certain management or development fees that were received by the equity investor from the entity or from other involved parties.

- Equity that was issued in exchange for a note from the equity investor that is payable in the future after the entity was created (refer to VE 4.1.1).
**4.1.1 Starting point: GAAP equity**

As noted above, the starting point for identifying equity at risk is identified as follows:

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**Excerpt from ASC 810-10-15-14**

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

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An analysis should be performed to understand the nature of the investments and to ensure that they would be reported as GAAP equity in the entity's financial statements. For example, if an entity was created after the effective date of the guidance in FAS 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* (FAS 150 now codified in ASC 480, *Distinguishing Liabilities from Equity* (ASC480)), and the entity issued date-certain redeemable preferred stock, those interests (the preferred stock) would not be recorded as GAAP equity and therefore would be excluded from equity at risk. However, temporary equity pursuant to EITF Topic D-98, *Classification and Measurement of Redeemable Securities* (codified as ASC 480-10), does represent and could be included in equity at risk provided that it meets all of the requirements described later in this section.

Changes in GAAP since the determination date do not affect the VIE analysis unless a VIE reconsideration event has occurred (refer to VE 4.3).

Slight changes in the form of the equity (especially certain preferred stock investments) may result in different consolidation conclusions. In addition, if a reconsideration event occurs (refer to VE 4.3) and if GAAP has changed since the prior determination date, an entity previously considered a voting interest entity may become a VIE. For example, upon adoption of the VIE model, the determination date for many entities created prior to February 1, 2003 preceded the effective date of the guidance in FAS 150. A VIE reconsideration event occurring after the adoption of the guidance in FAS 150 may cause certain equity previously to be deemed at risk to be reclassified as debt and no longer considered equity at risk for purpose of evaluating VIE status.

Often, entities are established with investments that economically are very similar to equity (e.g., subordinated debt), but are not reported as equity for GAAP purposes. These investments cannot be considered part of the equity investment at risk.

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**Excerpt from ASC 810-10-25-47**

...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.
In addition, commitments to fund the future operations of the entity, or promises to provide cash in the future in exchange for an equity interest (i.e., a stock subscription) are generally not considered GAAP equity, as they would not be reported as equity in the entity’s financial statements and should be excluded from the equity investment at risk. Additionally, since an equity subscription receivable is generally accounted for by recording an equal and offsetting debit in the equity section of the entity’s financial statements, it would reduce the equity investment.

What’s next: Is it at risk?

After an identification of the components of GAAP equity, the next step is to assess whether the equity is considered at risk for purposes of the analysis under the VIE model. There are four conditions (see VE 4.1.2-.5) that the reporting entity must consider to conclude that GAAP equity is at risk under the VIE model. If there is more than one investor, the reporting entity must evaluate each investment separately against the four conditions.

### 4.1.2 Equity must participate significantly in the entity’s profits and losses

**Excerpt from ASC 810-10-15-14(a)(1)**

Includes only equity investments in the legal entity that participate significantly in profits and losses even if those investments do not carry voting rights.

Based on our discussions with the FASB staff, the terms “profits and losses” refer to GAAP profits and losses (as opposed to expected losses and expected residual returns). This means that the equity investment must share (or participate) in the net income or loss of the entity. Some equity investments may share only in the profits of the entity and are not exposed to the losses of the entity. In that case, the equity investment would not be considered at risk. For example, while equity investors that receive a minimum guaranteed return of their investment participate in the profits of the entity, they may not necessarily participate in the losses of the entity. Thus, such equity may not be at risk.

Even if the equity investment shares in the profits and losses of the entity, the participation must be “significant.” The final determination of whether an equity investment participates significantly in profits and losses is based solely on the specific facts and circumstances. The following key factors should be considered when making this assessment:

- **Fixed rates of return or low levels of returns or loss**

  Generally, investments with a fixed rate of return do not participate significantly in profits and losses. However, there may be circumstances whereby the substance should govern over form. If the fixed rate of return is substantial to the overall equity return, the fixed rate of return could be viewed in essence as participating significantly in profits and losses. For example, preferred stock with a fixed dividend of 10 percent in an entity expected to generate a rate of return of 15 percent on its invested capital would generally be considered to participate
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significantly in the profits. Conversely, preferred stock with a fixed dividend of 8 percent in an entity expected to generate a rate of return of 35 percent is generally considered to be more debt-like in its return and would not be considered to participate substantively in the profits.

In addition, an equity investment that participates at a level that is consistent with its equity ownership (e.g., a 1 percent general partnership interest that participates in 1 percent of the entity’s profits and losses) would participate significantly in profits and losses.

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

- **Certain put or redemption rights**
  
  Oftentimes, investors can redeem or put their equity interests at fixed prices or prices determined based on a formula. Generally, when an investment has these puttable characteristics (i.e., the investor has the ability to put an equity investment back to other investors or the entity), it would not participate significantly in the losses of the entity. However, it is important to consider whether these put features substantively protect the investor’s investment or limit exposure to risks and rewards.

Other factors to consider include the following:

- Whether the length of the period during which the put option may be exercised varies.

- Terms associated with the put option, including the price at which the investment may be sold or bought (e.g., fixed, variable, or fair market value).

Sometimes equity interests are issued for a de minimis amount and, as a result, that investor may not participate significantly in losses. For example, consider a situation where a general partner purchases a 1 percent general partner interest for $1,000, while the limited partners contribute $1,000,000 for each of the remaining 1 percent interests. Under this scenario, the general partner’s interest would not be viewed as participating significantly in the losses of the entity. In making this assessment, we believe that both the dollar amount of the investment and the percentage of the investment to the total equity investments should be considered.
4.1.3 **Equity investments issued in exchange for subordinated financial support in another VIE**

**Excerpt from ASC 810-10-15-14(a)(2)**

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

The objective of this provision is to ensure that a particular equity investment is not used to capitalize two entities (i.e., the equity investment should count only once). For example, if Reporting Entity X uses cash to capitalize Entity A (a VIE), and then uses its equity interest in Entity A to capitalize Entity B (a VIE), the equity investment that Reporting Entity X holds in Entity B is not at risk because it was capitalized with a beneficial interest in Entity A.

4.1.4 **Equity investments provided to the equity investor by other parties involved with the entity**

**Excerpt from ASC 810-10-15-14(a)(3)**

Does not include amounts provided to the equity investor directly or indirectly by the legal entity or by other parties involved with the entity (for example, by fees, charitable contributions, or other payments), unless the provider is a parent, subsidiary, or affiliate of the investor that is required to be included in the same set of consolidated financial statements as the investor.

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

The guidance provides the following examples of factors that can result in a reduction in an investor’s at risk equity:

- **Fees**: Paid either upfront or over time (i.e., structuring, syndication, management, development fees, etc.).

- **Charitable contributions**: Specifically, those made on behalf of an investor.

Payments and fees paid by **any** party that is involved with the entity need to be evaluated to determine whether they disqualify the investor’s equity investment from being at risk.

A literal reading of the guidance suggests that all fees paid to equity investors by the entity itself, or by others involved with the entity, would reduce the equity investment at risk. We believe that the facts and circumstances must be evaluated to determine whether such fees are, in substance, a return of the capital and therefore reduce the amount of equity at risk.
We believe that the following factors should be considered in this evaluation:

□ **Upfront fees and unconditional fees paid over time:** Generally, fees that are paid concurrent with the formation of an entity (or shortly thereafter) or unconditional fees to be paid over time would be considered a return of the amounts invested by the equity investor. This would be true even when the fee paid is commensurate with the fair value of the services performed (and can be objectively verified). For example, Reporting Entity X contributes $15 in cash to form Entity A. Entity A obtains $85 of nonrecourse debt and pays Reporting Entity X $10, which represents a fair-value fee for the development services Reporting Entity X will perform in the future. The total equity investment at risk would be $5 ($15 less the $10 fee). Another example is a syndication fee that a general partner may receive when it forms and syndicates an entity. Assume that the general partner receives a $1,000 syndication fee and then contributes $10 for a 1 percent general partner interest. In this case, the general partner’s investment would not qualify as equity at risk.

□ **Third-party reimbursements:** Generally, payments that an equity investor receives from the entity and uses to pay an unrelated third party for a service that the unrelated third party performed for the entity would not affect the amount of the investor’s equity investment at risk. In these cases, the investor does not benefit from the monies received, so the amount invested in the entity is still at risk.

□ **Fees paid in the future not at fair market value:** Some fees paid over time may be considered a reduction of the equity investment at risk. Generally, if the present value of future fees exceeds the fair value of the services that are to be provided, then the excess payment reduces the equity investment at risk. We believe that in most cases, it is difficult to justify off-market fees as anything other than a return of capital.

□ **Fees paid in the future at fair market value:** Generally, fees that are paid in the future and represent the fair value for services to be provided in the future are not considered a reduction of the equity investment at risk.

### 4.1.5 Equity investments financed for the equity investor by the entity or other parties involved with the entity

**Excerpt from ASC 810-15-14(a)(4)**

Does not include amounts financed for the equity investor (for example, by loans or guarantees of loans) directly by the legal entity or by other parties involved with the legal entity, unless that party is a parent, subsidiary, or affiliate of the investor that is required to be included in the same set of consolidated financial statements as the investor.

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

In these circumstances, the funding that supports the entity is provided by parties other than the equity investor. The guidance specifically states that such interests are not considered equity at risk.

In addition, a party that receives its interests as a contribution or a loan from the reporting entity is a de facto agent of the reporting entity. This may have significant ramifications. For example, assume that Investor A loans Investor B $500 and Investor B uses the $500 to acquire a 50 percent interest in Partnership X. Investor A contributes $500 in cash and also receives a 50 percent interest in Partnership X. Investor B would not have an equity investment at risk because Investor A provided the financing for that investment. In addition, Investor A and Investor B would be considered as related parties (de facto agents) under the VIE model.

4.1.6 Consideration of activities around the entity

Transactions that occur outside the potential variable interest entity should be considered to determine whether the equity investment is at risk.

Jane Poulin of the SEC Staff has shared this view at the 2004 AICPA Conference on SEC and PCAOB Developments. Although her comments were made in the context of the earlier VIE model, the general premise is also applicable to the guidance in the VIE model. In her comments, Ms. Poulin stated the following:

We have seen a number of questions about whether certain aspects of a relationship that a variable interest holder has with a variable interest entity (VIE) need to be considered when analyzing the application of FIN 46R (ASC 810). 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 an entity and Investor A separately made a loan with full recourse to another variable interest holder (Investor B). We have been asked whether the loan in this situation can be ignored when analyzing the application of FIN 46R (ASC 810). The short answer is no. First, FIN 46R (ASC 810) specifically requires you to consider loans between investors as well as those between the entity and the entity in determining whether equity investments are at risk, and whether the at risk holders possess the characteristics of a controlling financial interest as defined in paragraph 5(b) of FIN 46R (ASC 810-10-15-14). It is often difficult to determine the substance of a lending relationship and its impact on a VIE analysis on its face. You need to evaluate the substance of the facts and circumstances. The presence of a loan between investors will bring into question, in this example, whether Investor B’s investment is at risk and depending on B’s ownership percentage and voting rights, will influence whether the at risk equity holders possess the characteristics of a controlling financial interest.
Other “activities around the entity” that should be considered when applying FIN 46R (ASC 810) include equity investments between investors, puts and calls between the entity and other investors and non-investors, service arrangements with investors and non-investors, and derivatives such as total return swaps. There may be other activities around the entity that need to be considered which I have not specifically mentioned. These activities can impact the entire analysis under FIN 46R (ASC 810) including the assessment of whether an entity is a VIE as well as who is the primary beneficiary.

4.2 Next steps: Assessing the five characteristics of a VIE

4.2.1 Characteristic 1: Insufficient equity investment at risk

One characteristic that must be assessed to determine whether an entity qualifies as a VIE focuses on the sufficiency of the VIE’s equity at risk. This assessment entails evaluating whether or not the entity is thinly capitalized (i.e., whether the amount of equity at risk is sufficient for the entity to finance its own activities). If the total equity investment at risk is insufficient, the entity is a VIE. This condition is premised on the notion that if the total equity investment at risk is insufficient to finance an entity’s activities, the parties providing the additional financing would restrict or even prohibit the equity investors from making decisions that are counter to the interests of the providers of additional financing. Consequently, placing primary reliance on voting rights, as prescribed by the voting interest model, may result in flawed conclusions when determining which party holds a controlling financial interest. This section discusses how to determine whether the equity investment at risk is sufficient for the entity to finance its operations, which entails the following:

□ Considering the initial presumption of insufficiency of equity (or the 10 percent presumption).

□ Overcoming the 10 percent presumption (and other qualitative and quantitative considerations).

□ Special considerations relating to development-stage enterprises.

Excerpt from ASC 810-10-15-14

A legal entity shall be subject to consolidation under the guidance in the Variable Interest Entities Subsections if, by design, any of the following conditions exist (The phrase by design refers to legal entities that meet the conditions in this paragraph because of the way they are structured. For example, a legal entity under the control of its equity investors that originally was not a variable interest entity [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 the other parties involved with the legal entity, unless that party is a parent, subsidiary, or affiliate of the investor that is required to be included in the same set of consolidated financial statements as the investor.

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

The VIE model includes a method for assessing the sufficiency of the equity investment at risk that is based on the potential negative variability in the returns of the entity—its expected losses. The equity investment at risk must be large enough to absorb the potential downside variability of the entity’s activities in order to be sufficient. The guidance indicates that either a qualitative and quantitative analysis (or both) may be used to evaluate the sufficiency of the total equity investment at risk.

4.2.1.1 Calculating the equity investment at risk

The following table provides an overview of how the amount of equity investment at risk in an entity is calculated:
Determining whether an entity is a VIE

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**Equity investment at risk (at fair value)**

<table>
<thead>
<tr>
<th>Less:</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>GAAP equity investment (i.e., fair value of the equity)</td>
<td></td>
</tr>
<tr>
<td>Less:</td>
<td>Equity investments that do not participate significantly in the entity’s profits and losses (see ASC 810-10-15-14(a)(1))</td>
</tr>
<tr>
<td>Less:</td>
<td>Equity investments in an entity that are the source of subordinated financial support for another VIE (see ASC 810-10-15-14(a)(2))</td>
</tr>
<tr>
<td>Less:</td>
<td>Equity investments provided to the equity investor by the entity or other parties involved with the entity (see ASC 810-10-15-14(a)(3))</td>
</tr>
<tr>
<td>Less:</td>
<td>Equity investments financed for the equity investor by the entity or other parties involved with the entity (see ASC 810-10-15-14(a)(4))</td>
</tr>
<tr>
<td>Equals:</td>
<td>Equity investment at risk (at fair value)</td>
</tr>
</tbody>
</table>

We believe that to determine the amount of the equity investment at risk, the securities included in GAAP equity should be evaluated based on their fair value on the determination date. That date may be different from the entity’s formation date. Also, the book value of the entity’s equity will not often represent the fair value of the equity. In addition, there are cases when, even at formation, the fair value of the equity is different from its book value (e.g., entities that are required by GAAP to carry over historical cost to record equity contributions such as in the formation of a joint venture). The concepts of variable interests and expected losses are based on fair-value assumptions about the entity’s activities and potential returns, thus using the fair value of equity will provide for consistent comparisons when evaluating whether an entity is a VIE.

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

An equity investment that is issued in return for an equity investor’s obligation to provide additional capital is not generally considered equity at risk, as the receivable recorded in equity is an offset to GAAP equity. If an investor is obligated to fund an entity’s activities on a continual basis, the entity may be a VIE. Additionally, an equity investor’s personal guarantee of an entity’s debt(s) is not part of the equity investment (i.e., it is not GAAP equity). However, the guarantee generally is a variable interest that may be called to provide financial support to the entity and the existence of such guarantees may be indicative of insufficient equity at risk.

**4.2.1.2 Assessing the sufficiency of the equity investment at risk**

The VIE model establishes a rebuttable presumption that all entities with an equity investment at risk of less than 10 percent of an entity’s total assets (at fair value) are VIEs. However, the guidance allows for that presumption to be overcome and states that either qualitative or quantitative evidence can be used to support an assertion that the equity investment at risk of less than 10 percent may be sufficient.
Excerpt from ASC 810-10-25-45

An equity investment at risk of less than 10 percent of the legal entity’s total assets shall not be considered sufficient to permit the entity to finance its activities without subordinated financial support in addition to the equity investment unless the equity investment can be demonstrated to be sufficient. The demonstration that equity is sufficient may be based on either qualitative analysis or quantitative analysis or a combination of both. Qualitative assessments, including but not limited to the qualitative assessments described in (a) and (b), will in some cases be conclusive in determining that the legal entity’s equity at risk is sufficient. If, after diligent effort, a reasonable conclusion about the sufficiency of the legal entity’s equity at risk cannot be reached based solely on qualitative considerations, the quantitative analyses implied by (c) shall be made. In instances in which neither a qualitative assessment nor a quantitative assessment, taken alone, is conclusive, the determination of whether the equity at risk is sufficient shall be based on a combination of qualitative and quantitative analyses.

a. The legal entity has demonstrated that it can finance its activities without additional subordinated financial support.

b. The legal entity has at least as much equity invested as other entities that hold only similar assets of similar quality in similar amounts and operate with no additional subordinated financial support.

c. The amount of equity invested in the legal entity exceeds the estimate of the legal entity’s expected losses based on reasonable quantitative evidence.

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

Excerpt from ASC 810-10-25-46

Some legal entities may require an equity investment at risk greater than 10 percent of their assets to finance their activities, especially if they engage in high-risk activities, hold high-risk assets, or have exposure to risks that are not reflected in the reported amounts of the legal entity’s assets or liabilities. The presumption in the preceding paragraph does not relieve a reporting entity of its responsibility to determine whether a particular entity with which the reporting entity is involved needs an equity investment at risk greater than 10 percent of its assets in order to finance its activities without subordinated financial support in addition to the equity investment.

In practice, 10 percent is not a bright line, and the sufficiency of equity needs to be assessed based on the facts and circumstances of each entity under analysis.
4.2.1.3 Qualitatively demonstrating that the equity investment at risk is sufficient

The VIE model does not include “rules” for determining what amount of equity is sufficient. The 10 percent presumption sets a “high hurdle” and does not provide a safe harbor for all equity investments that are equal to or greater than 10 percent of the entity’s total assets. Reporting Entities involved with entities must demonstrate that the equity investment at risk is sufficient, even if the equity exceeds 10 percent of the assets.

If equity at risk is less than 10 percent of the entity’s assets, the qualitative and quantitative factors should be assessed to overcome the presumption of insufficiency of the equity investment at risk. If equity at risk is more than 10 percent, these factors should also be assessed to ensure its sufficiency. The qualitative analysis must be performed before the quantitative analysis. However, we believe that in certain cases the qualitative analysis may not, in and of itself, provide sufficient substantive evidence to support a conclusion that the equity investment at risk is sufficient, particularly, when an entity’s capital structure is complex. Therefore, although the sufficiency of equity at risk guidance might seem easy to overcome, it is in reality often difficult to demonstrate the adequacy of the equity based on a qualitative assessment of the existing structure. For example, it is clear that numerous arrangements between reporting entities and an entity (or parties involved with the entity) can be variable interests. When an entity has a simple capital structure for which the only variable interests are debt and equity, this qualitative analysis may be straightforward. This qualitative analysis will be more difficult for more complex capital structures in which there are numerous variable interests (e.g., derivatives, guarantees, etc.).

Often, entities obtain nonrecourse financing as their only means of purchasing assets. This does not necessarily demonstrate that the equity investment at risk is sufficient.

Excerpt from ASC 810-10-25-47

The design of the legal entity (for example, its capital structure) and the apparent intentions of the parties that created the legal entity are important qualitative considerations, as are ratings of its outstanding debt (if any), the interest rates, and other terms of its financing arrangements. Often, no single factor will be conclusive and the determination will be based on the preponderance of evidence. For example, if a legal entity does not have a limited life and tightly constrained activities, if there are no unusual arrangements that appear designed to provide subordinated financial support, if its equity interests do not appear designed to require other subordinated financial support, and if the entity has been able to obtain commercial financing arrangements on customary terms, the equity would be expected to be sufficient. In contrast, if a legal entity has a very small equity investment relative to other entities with similar activities and has outstanding subordinated debt that obviously is effectively a replacement for an additional equity investment, the equity would not be expected to be sufficient.

Financing obtained which is other than equity (e.g., through debt) may demonstrate the sufficiency of the equity. However, since debt may function as a surrogate for
additional equity investment, the quality of the debt and associated interest rate are important factors to consider in this analysis. We believe that the ability to obtain investment-grade debt (at least a rating of BBB by Standard and Poor’s or Baa by Moody’s) may be evidence that the equity investment at risk is sufficient and that the lender’s risk of loss is remote. On the other hand, higher-risk financing may indicate that the lender (or other parties) shares in the risks of the entity’s activities (i.e., absorbing some or all of the entity’s expected losses). What makes this assessment more difficult is that debt is not the only type of variable interest that may provide additional subordinated financial support. The existence of guarantees on the value of assets, non-fair value options to put an equity investment to other parties, and similar arrangements are also variable interests that often provide additional subordinated financial support and may even impact the quality of the debt that the entity can procure.

We believe that depending on the facts and circumstances of the arrangement, the existence of guarantees of an entity’s debt may indicate that the equity investment at risk is insufficient. For example, if a personal guarantee was necessary for the entity to receive financing from a third-party bank, the equity investment at risk may not be sufficient. Otherwise, the bank would not have negotiated for such guarantee or the equity investors would not have been willing to provide the guarantor if such guarantees were not necessary for receiving the financing under the terms provided.

Traditionally viewed SPEs

Historically, special purpose entities (SPEs) were “thinly capitalized,” and most SPEs were structured under the previous accounting rules, which stated that the total equity investment only needed to be 3 percent of the entity’s total assets. Instead of equity investments that were exposed to the residual risks and rewards of ownership in an SPE, other arrangements with the entity, or other parties associated with the entity, bore most of the risk of loss related to the entity’s activities and often received most of the residual benefit of the SPE’s activities (i.e., these contracts functioned in a manner that is often associated with an equity investment). SPEs will often be VIEs because the equity investment at risk will be insufficient.

4.2.1.4 Quantitatively demonstrating that the equity investment at risk is sufficient

If the qualitative assessment is not conclusive, reporting entities must perform a quantitative analysis, comparing the entity’s equity investment at risk to its expected losses. The equity investment at risk can be presumed to be sufficient if it exceeds the estimate of the entity’s expected losses based on reasonable quantitative evidence.

As discussed earlier, a significant factor in the quantitative analysis is the calculation of the entity’s expected losses. If the expected losses of the entity are greater than the fair value of the total equity investment at risk, the entity is a VIE. The calculation of expected losses is discussed in VE 1.6.

If neither the quantitative nor qualitative analysis is conclusive, the results from each analysis should be considered in combination so that a reasonable assessment can be made.
4.2.1.5 Development stage entities

The VIE model includes special provisions for entities that are in the developmental stage.

Excerpt from ASC 810-10-15-16

Because reconsideration of whether a legal entity is subject to the Variable Interest Entities Subsections is required only in certain circumstances, the initial application to a legal entity that is in the development stage is very important. Guidelines for identifying a development stage entity appear in paragraph 915-10-05-2. A development stage entity is a VIE if it meets any of the conditions in paragraph 810-10-15-14. A development stage entity does not meet the condition in paragraph 810-10-15-14(a)) if it can be demonstrated that the equity invested in the legal entity is sufficient to permit it to finance the activities it is currently engaged in (for example, if the legal entity has already obtained financing without additional subordinated financial support) and provisions in the legal entity's governing documents and contractual arrangements allow additional equity investments. However, sufficiency of the equity investment should be reconsidered as required by paragraph 810-10-35-4, for example, if the legal entity undertakes additional activities or acquires additional assets.

ASC 915, Development Stage Entities (ASC 915), (specifically ASC 915-10-05-2) provides guidance on identifying development stage entities. The FASB allows the use of a different model when assessing the total equity investment at risk for development stage entities. When evaluating a development-stage entity, only the current phase of development (i.e., the phase for which financing has already been obtained) should be considered. Thus, in order for entities in the development stage to avoid being considered VIEs, the entity must have equity that is sufficient to permit it to finance the activities in its current phase (i.e., the activity in which the entity is currently engaged). Additionally, provisions in its governing documents must enable the entity to obtain additional equity capital that will allow it to finance future phases. Thus, some development stage entities may be VIEs if the entity’s governing documents do not provide for additional equity investments in subsequent phases.

Other points to consider regarding development stage entities include the following:

- This exception applies to only the sufficiency of equity at risk criterion. Thus all of the other characteristics of a VIE must also be assessed to determine whether a development stage entity is a VIE.

- Although some development stage entities may not be deemed VIEs when initially evaluated, subsequent events may occur that cause such entities to become VIEs. If reconsideration events specified in the VIE model occur, such entities must be re-evaluated to determine if they have become VIEs as of the reconsideration date (refer to VE 4.3).
4.2.2 **Characteristic 2: Equity lacks decision making rights**

One of the characteristics of a VIE is that the equity holders at risk lack decision making rights. The guidance under the VIE model aligns the analyses of whether the equity holders at risk lack decision making rights with the qualitative analysis of determining the primary beneficiary. Consequently, an entity would be a VIE if, 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 an entity that most significantly impact the entity’s economic performance.

**Excerpt from ASC 810-10-15-14(b)(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. The investors do not have 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 or a general partner in a partnership). Legal entities that are not controlled by the holder of a majority voting interest because of noncontrolling shareholder veto rights as discussed in paragraphs 810-10-25-2 through 25-14 are not VIEs if the shareholders as a group have the power to control the entity and the equity investment meets the other requirements of the Variable Interest Entities Subsections. Kick-out rights or participating rights 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 the fees paid to the decision maker represent a variable interest based on paragraphs 810-10-55-37 through 55-38.

**Excerpt from ASC 810-10-20**

Kick-out rights are the ability to remove the reporting entity with the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance.

Participating rights are the ability to block the actions through which a reporting entity exercises the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance.

4.2.2.1 **Key consideration of whether equity lacks decision making rights**

The underlying principle of this characteristic acknowledges that if the equity investors at risk do not possess the power to direct the activities that have the most significant impact on the economic performance of the entity, it can be concluded that a party other than the equity investor(s) most likely controls the entity. As a result, the FASB included this characteristic of a VIE to capture entities where the power to direct those decisions that most significantly impact the economic performance of the
entity are not held by the equity investors at risk. Specifically, the issue centers on whether, as a group, the equity investors at risk have embedded in their rights the key decisions of the entity that can impact its economic performance. Fundamentally, if the economic interests in the entity that are outside of the equity investment at risk (e.g., debt interests or management contracts) also provide the holders of those interests with a substantive power to direct the activities that have the most significant impact on the economic performance of the entity, the entity would generally be considered a VIE.

4.2.2.2 Which parties should be evaluated under this characteristic?

The reporting entity must analyze this characteristic as it analyzes each of the five VIE characteristics. The following tasks should be included in this analysis:

- Identify the investments that qualify as equity investment at risk.
- Group those equity investments at risk together, as if they were held by a single party.
- Evaluate whether the grouped equity investments at risk have the power through their voting rights or similar rights to direct the activities of the entity that most significantly impact the entity’s economic performance.

If one member of the equity investors at risk group holds the decision making rights through the terms of equity (e.g., as general partner or managing member of a limited liability corporation), then the decision making rights would be considered to be held by the entire group.

Our experience suggests that complex capital structures pose unique challenges and, as a result, require careful analysis. There might be situations in which interests that are not considered equity at risk possess voting rights, but nevertheless do not cause the entity to qualify as a VIE as illustrated below.

EXAMPLE 4-1

Assume that in a newly formed corporation 40 percent of the common shares were granted to a third party as a contribution. As discussed in VE 4.2.5, the third party’s equity would not be considered part of the equity investment at risk. The remaining 60 percent of the common shares reside with the holders of the equity investment at risk. Each investor has voting rights in proportion to its equity-ownership percentage. Since all decisions that significantly impact economic performance are made by equity holders based upon a simple majority vote of their shares, the existence of the 40 percent voting interest held by a party that does not have equity at risk would not cause the entity to be considered a VIE with respect to this characteristic.

4.2.2.3 How to evaluate whether the equity holders as a group have power

Determining which activities most significantly impact the entity’s economic performance may require significant judgment. In certain circumstances, an entity’s operations may be straightforward or one dimensional. In those instances,
determination of whether or not the holders of the equity investment at risk meet the power criterion may not require significant judgment. Critical to this analysis is to identify the decisions of the entity and how the decisions could affect the economic performance of the entity. It is important to consider the design of the entity in making this determination. Once the key decisions are determined, it must then be ensured that the decisions are made by the group of equity investors at risk rather than by parties outside of that group.

As mentioned in VE 1.8, the VIE model introduced a new definition of participating rights that are not applicable to transactions accounted for under other authoritative guidance. If any participating rights are predetermined and/or provided to parties other than the holders of the equity investment at risk (such as a lessee or a lender), it would be difficult to conclude that the equity group at risk controls the entity’s operations. For example, if debt holders have the ability to veto operating and capital decisions (including decisions that establish an entity’s budgets) and the corporate entity does not have the right or ability to refinance the debt, substantive decision making ability would not rest with the equity group at risk. As a result, the corporate entity would likely be considered a VIE.

For the purposes of assessing whether the holders of the equity investment at risk lack power to make decisions with respect to activities that most significantly impact the entity’s economic performance, kick-out rights (which for the purposes of the VIE model only include removal rights and do not generally include liquidation rights) and participating rights are ignored unless those rights can be exercised by one party (including its related parties and de facto agents) and are substantive. This approach to removal rights is consistent with the guidance for determining the primary beneficiary of a VIE as discussed in VE 5. However, it is inconsistent with the evaluation of substantive kick-out rights under the voting-interest model (i.e., ASC 810-20-25) which includes liquidation rights and also respects kick-out rights that are held by more than one party as long as they are substantive.

**EXAMPLE 4-2**

Entity XYZ owns and operates a theme park. Assume that the decisions that significantly impact the performance of the entity include making capital investments such as incurring capital expenditure for new rides to continue to attract visitors to the theme park. Entity XYZ typically funds it capital investments via a mix of equity and debt financing. However, all capital investment decisions involving new rides need the lender’s approval (one party).

In this example, since the lender is one party that has the ability to exercise a participating right relating to an activity of the entity which has a significant impact on the entity’s performance, Entity XYZ would be considered to be a VIE under Characteristic 2: Equity Lacks Decision Making Rights.

It is important to note that a service arrangement that provides an entity the power to direct the activities of an entity that significantly impact the entity’s performance but is not a variable interest in the entity, such interest will not cause the entity to become a VIE under Characteristic 2. The FASB concluded that if the power to direct
the activities of an entity that significantly impact the entity’s performance are made by a fiduciary, then such decisions merely are to the benefit of the equity investors. As a result, fiduciary service contracts (i.e., those that are not variable interests under the VIE model) would not cause the entity to become a VIE under Characteristic 2.

**EXAMPLE 4-3**

Entity ABC owns and operates data centers in several locations. The data centers house their customers’ servers, provide Internet connectivity and are contractually committed to have the servers operational for 99.97 percent of the time otherwise Entity ABC would be subject to payment of heavy penalties. A reporting entity provides maintenance services to the data center that are critical for the data center’s operations. Under the maintenance agreement, the reporting entity makes all the decisions to maintain the data centers and keep them up and running for at least 99.97 percent of the time. The reporting entity has no other interest in the entity. The maintenance arrangement meets all the conditions in ASC 810-10-55-37 such that the maintenance fee paid to the reporting entity is not a variable interest.

In this example, even though the reporting entity makes all the critical decisions that have a significant impact on the performance of Entity ABC, the maintenance fee is not a variable interest and Entity ABC will not become a VIE under Characteristic 2: Equity Lacks Decision Making Rights.

While the model for determining the primary beneficiary and determining whether the equity investors as a group have this characteristic are aligned, we believe that the FASB intended that entities that have limited decisions based on their design and governance documents would not be VIEs under this characteristic.

**4.2.2.4 Evaluating limited partnerships and the impact of kick-out rights**

In evaluating whether a general partner is required to consolidate a limited partnership under the voting model (ASC 810-20 and ASC 970-323-25-3 through 25-8), the general principle is that the general partners in a limited partnership are presumed to control that limited partnership regardless of the extent of the general partners’ ownership interest in the limited partnership. As stated in ASC 810-20 and ASC 970-323-25-3 through 25-8, the assessment of whether the rights of the limited partners should overcome the presumption of control by the general partners is a matter of judgment that depends on facts and circumstances. The general partners do not control the limited partnership when it is a voting interest entity if the limited partners have either (a) the substantive ability to dissolve (liquidate) the limited partnership or otherwise remove the general partners without cause (known collectively as “ASC 810-20 kick-out rights”) or (b) substantive participating rights.

Under the voting interest model, ASC 810-20 and ASC 970-323-25-3 through 25-8 offer additional guidance on this evaluation and on the following related topics:

- Assessing whether ASC 810-20 kick-out rights are substantive and whether they can be exercised by a single limited partner or a simple majority (or a lower
Determining whether an entity is a VIE

percentage) of the limited partners’ voting interest held by parties other than the general partner as well as barriers to exercise such vote, and

- Distinguishing between protective and participating rights for which the guidance is generally consistent with ASC 810-10-25.

In certain fact patterns, it may be determined that the general partner equity interest may not be considered at risk. In those fact patterns, under the VIE model, an evaluation of limited partner investments at risk must be undertaken to determine whether those limited partners as a group have the controlling financial interest of the entity. The VIE model requires that in order for the limited partners as a group to possess a controlling financial interest, a single limited partner (including its related parties and de-facto agents) whose equity is determined to be at risk has to possess the ability to remove the general partner (whose equity is not at risk). Further, while the model in ASC 810-20 and ASC 970-323-25-3 through 25-8 is not specifically designed for the evaluation of whether a limited partner has a controlling financial interest, the use of this guidance by analogy can be helpful in making the assessment of whether such removal right is substantive. If that removal right is determined to be substantive under ASC 810-20 and ASC 970-323-25-3 through 25-8, it would be determined that the limited partners as a group hold the controlling financial interest (i.e., the ability to make decisions that could have a significant effect on the entity).

Some believe that substantive liquidation rights, as defined in ASC 810-20, held by a single limited partner (including its related parties and de-facto agents) whose equity is at risk, automatically represents a controlling financial interest. We do not believe that a single limited partner (including its related parties and de-facto agents) whose equity is at risk with substantive liquidation rights, as defined in ASC 810-20 and ASC 970-323-25-3 through 25-8, holds a controlling financial interest, unless those liquidation rights are designed in a manner that is consistent with removal rights. Substantive liquidation rights would only indicate that a controlling financial interest exists if the liquidation rights are designed so that the limited partner could liquidate the entity and establish a new limited partnership with a new general partner to own the same assets and pursue the same objectives of the previous partnership. Given these circumstances, the right and ability of the limited partner to liquidate would be, in substance, no different than a removal right. However, this is generally not the case, as the limited partner generally would not have the ability to retain ownership of the same assets of the entity through liquidation. Accordingly, the entity would be considered a VIE with respect to the second characteristic. See VE 5.1.2 for kick-out rights.

Lastly, the mere fact that a single limited partner holds substantive participating rights is not sufficient to conclude that the limited partner has a controlling financial interest, since such limited partner will only have the ability to block or participate in decisions made by the general partner.

Given below is a summary that is helpful in evaluating when a limited partnership is a VIE and in case it is not a VIE, the evaluation under the voting interest model:
### Determining whether an entity is a VIE

<table>
<thead>
<tr>
<th>General partner equity considered at risk</th>
<th>Substantive kick-out rights held by one limited partner investor</th>
<th>Substantive kick-out rights held by multiple limited partner investors</th>
<th>No substantive kick-out rights</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>If the entity is not deemed a VIE after assessing all of the remaining characteristics (i.e., Characteristic 1, 3, 4, and 5), General Partner does not consolidate under ASC 810-20.</td>
<td>If the entity is not deemed a VIE after assessing all of the remaining characteristics (i.e., Characteristic 1, 3, 4, and 5), the General Partner does not consolidate under ASC 810-20.</td>
<td>If the entity is not deemed a VIE after assessing all of the remaining characteristics (i.e., Characteristic 1, 3, 4, and 5), the General Partner consolidates under ASC 810-20.</td>
</tr>
<tr>
<td>General partner equity NOT considered at risk</td>
<td>Not a VIE under Characteristic 2.</td>
<td>VIE under Characteristic 2.</td>
<td>VIE under Characteristic 2.</td>
</tr>
<tr>
<td></td>
<td>If the entity is not deemed a VIE after assessing all of the remaining characteristics (i.e., Characteristic 1, 3, 4, and 5), General Partner does not consolidate under ASC 810-20.</td>
<td>General Partner likely consolidates under the VIE model as it has power (decision making) and benefits/losses.</td>
<td>General Partner likely consolidates under the VIE model as it has power (decision making) and benefits/losses.</td>
</tr>
</tbody>
</table>

Note: The above chart does not take into account the effect of related parties on the evaluation as to whether the general partner’s equity is considered at risk (see VE 4.2.2.4.1). In addition, the phrase “Substantive Kick-Out Rights Held by Multiple Limited Partner Investors” is meant to be those kick-out rights that comply with ASC 810-20-25-8 through 10.

In assessing who may hold the controlling financial interest in a limited liability corporation (LLC), the corporation model or the limited partnership model should be considered depending on whether the entity is the functional equivalent of a limited partnership as described in ASC 810-20. To understand an entity’s underlying governance structure and to conclude whether it functions like a limited partnership or a corporation, a detailed analysis should be performed based on the facts and circumstances specific to a particular entity’s formation and governing documents. The evaluation of an LLC should consider whether a managing member or some other member of the LLC has significant decision making (or other) rights regarding the operation of the entity that are similar to the rights held by the general partner of a limited partnership. In some cases, a board is used instead of a managing member. Much like a corporation’s board of directors, this board would vote on all significant decisions. An evaluation of an LLC might also take into account how voting percentages are allocated to the investors and what decision making rights are granted to parties that hold limited-partnership interests.
4.2.2.4.1 General partner’s interests in a limited partnership

Questions have arisen regarding how the presence of a general partner that does not hold a substantive equity investment in a limited partnership, but that has related parties that hold investment(s) in the fund should be evaluated under the VIE model. Consider the following fact pattern:

The general partner in a limited partnership is required under the terms of the partnership agreement to hold a 0.1 percent investment in the limited partnership. However, the general partner did not make any contribution for its interest in the $10,000,000 limited partnership. In addition, the general partner or related parties of the general partner may also hold a substantive investment in the limited partnership through a limited partner interest in the entity, which were obtained on a basis similar to other limited partners investors. This is commonly done for marketing purposes to align the interest of the sponsor group with the limited partners by requiring them to have “skin in the game.” All substantive decision making rights are held by the general partner, and no kick-out rights are held by the limited partners (i.e., there is no ability for the limited partners to remove the general partner).

Since the general partner did not make an investment in the limited partnership, the general partner’s interest would not normally be considered equity at risk under the VIE model. This fact pattern would generally result in the limited partnership being a VIE because the holders of the equity investment at risk (i.e., the group of limited partners) do not have decision making rights or the ability to kick-out the general partner.

However, because related parties of the general partner have made a substantive investment in the entity, the analysis becomes more complex. The specific facts of the structure must be carefully evaluated to determine whether the holders of the equity investment at risk have decision making abilities through their relationship with the decision maker (i.e., the general partner in this particular fact pattern).

When determining whether the economic interest held by related parties of the general partner should be combined with the controlling interest of the general partner to conduct the decision making test, the rebuttable presumption is that the controlling interest should be combined with the economic interests of all related parties. The combination of those interests will generally alleviate decision making exception and cause the fund to be a voting interest entity, unless one of the other characteristics of a VIE is met.

The presumption that the economic interests of a related party should be combined with those of the general partner may be overcome based on facts and circumstances. Consideration should be given to whether the general partner has the ability to arbitrarily choose the legal entity that will hold the economic interest in the fund and whether the economic risks and rewards associated with that interest will ultimately revert to the general partner. If the economic interest held by the related party is independent of the general partner’s influence (both from a control and economic perspective), the presumption that combining interests is appropriate may be overcome. For example, the presumption may be overcome if (1) management or employees of the general partner make investments in the entity, (2) management and
Determining whether an entity is a VIE

the employees are able to invest and withdraw the fair value of their funds at their own discretion, (3) the investments are made from compensation that is deemed to be at fair value, and (4) investment returns have no impact on future compensation levels.

Given the significant diversity in structure of partnerships and general partner management agreements, specific facts and circumstances must be considered in all such arrangements.

The above observation is consistent with a speech from Mark Mahar of the SEC Staff at the 2006 AICPA Conference on SEC and PCAOB Developments, where he stated the following:

We understand that certain general partner (GP)/limited partner (LP) arrangements have become common in which the partnership might be considered a variable interest entity (VIE).

When the GP considers its relationship with the entity in isolation, it comes to the conclusion that the entity is a VIE because the holders of the equity investment at risk as a group, i.e., the LPs, do not have the ability to make decisions about the entity’s activities that have a significant effect on its success.

However, a view that analyzes the GP and the entity in isolation seems to be incomplete because of the relationships with certain of the LP investors. Depending on the significance of those relationships, I believe the GP and LPs may be so closely associated that it is most appropriate to consider their interests in the aggregate. This analysis depends heavily on the particular facts and circumstances, thus a degree of reasonable judgment is necessary.

If the GP and LP are considered a group, the FIN 46R [ASC 810] analysis could yield different results. If the GP and certain LP equity interests are combined, then the entity, all other things being equal, would likely pass the paragraph 5(b)(1) [ASC 810-10-15-14 (b) (1)] test. That is, the equity holders as a group, inclusive of the GP rights, would have the ability to make decisions about the entity’s activities that affect its success. The result would be the entity is not a VIE and the accounting consideration would revert to the voting interest model with the GP consolidating.

If the GP and LP are considered a group, the FIN 46R [ASC 810] analysis could yield different results. If the GP and certain LP equity interests are combined, then the entity, all other things being equal, would likely pass the paragraph 5(b)(1) test. That is, we understand that some of these structures may have been designed specifically to circumvent EITF 04-5 [ASC 810-20], which would generally result in consolidation by the GP if the partnership is not a VIE. This gives me a chance to make the point that using professional judgment is not a cover or license to engineer around the intent of accounting literature. Frankly, it’s attempts like this that often lead to restatements and more accounting standards as the standard setters seek to close the door on abusive transactions. I do not like complex standards any more than you. With more restatements and complex standards, no one is a winner, investors, preparers and auditors alike.
4.2.2.5 **Decision making must reside within the equity instrument**

As a group, the equity holders at risk must have both the power to direct the activities that most significantly impact the entity’s economic performance and the obligation to absorb expected losses or the right to receive the expected residual returns of the entity.

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

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

It is also important to consider that the objective of this characteristic is to identify as VIEs those entities in which the total equity investment at risk does not provide the holders of that investment with the characteristics of a controlling financial interest. Therefore, a reporting entity must evaluate the rights of the equity group at risk, which includes those that are embedded in the group’s equity interests. However, if the equity group has rights that are not embedded in their equity interests in the entity, those rights would be considered rights outside of the group’s equity interests. For example, if an equity holder at risk has significant decision making abilities pursuant to a management contract, rather than through its equity interests, and the equity group at risk cannot remove the manager, the rights under the management contract should not be attributed to the equity group at risk. Consequently, the entity would likely be considered a VIE.

This form-based distinction can lead to inconsistent conclusions when the substance of the transactions is similar. Therefore, this analysis should be carefully performed. Specifically, the existence of decision making outside of the equity instruments should be evaluated to determine if there is commercial substance in structuring the arrangements in this manner. If decision making outside of the equity at risk instruments is deemed a formality, this would suggest that the decision making ability may be held by the equity investors.

For example, super-voting common stock that gives a noncontrolling shareholder control of the entity would not cause the entity to be a VIE with respect to this characteristic (provided that such investor’s equity is at risk). However, if the noncontrolling shareholder obtained control of the entity through a management contract, the entity might be considered a VIE. Similarly, we believe that if decision making is determined by a shareholders’ agreement (i.e., a separate contractual arrangement among the shareholders that gives voting control to some of the shareholders and not to others) and all parties to the shareholder agreement are holders of equity investment at risk, the entity would not necessarily be considered a VIE. In contrast, the existence of contractual decision making service arrangements between an entity and an equity investor may cause the entity to be considered a VIE with respect to this characteristic.

In many fact patterns, determining whether decision making rights are held within the equity interest can be difficult in practice. This is particularly true in assessing
whether a general partner’s interest holds the decision making rights in a limited partnership when there are separate management contracts held by the general partner’s related parties. In such cases, the following questions should be considered:

- **What is the ownership structure of/relationship between the general partner and the related party that holds the investment management agreement (i.e., whether the entities are commonly controlled)?** In the event that the general partner and investment manager are controlled by the same parent and the substance of the arrangement is that the investment decisions are effectively made by an equity investor at risk (due to the common control relationship of the investment manager and the general partner), it could be determined that the significant decision making rights remain within the equity group at risk.

- **Does the general partner have the legal right to sell/transfer its decision making rights to an unrelated entity?** Specifically, the reporting entity should consider whether the right to appoint the investment manager remains with the general partner interest, if the general partner’s interest is sold to an outside party. If the legal right to appoint the investment manager always remains with the general partner’s interest, the substantive decision making rights may still reside with the equity holders as a group, and no decision making exception would be present (i.e., the entity would not be considered a VIE with respect to Characteristic 2).

- **Does the general partner have the legal right to terminate the investment management agreement?** If the general partner holds the legal right to terminate the investment management agreement at any time and at its sole discretion, the equity group at risk has most likely retained the substantive decision making rights of the entity. All factors including penalties associated with early termination should be considered to determine whether or not the termination right is substantive.

### 4.2.3 Characteristic 3: Equity with nonsubstantive voting rights

**Excerpt from ASC 810-10-15-14(c)**

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

1. The voting rights of some investors are not proportional to their obligations to absorb the expected losses of the legal entity, their rights to receive the expected residual returns of the legal entity, or both

2. Substantially all of the legal entity’s activities (for example, providing financing or buying assets) either involve or are conducted on behalf of an investor that has disproportionately few voting rights. This provision is necessary to prevent a primary beneficiary from avoiding consolidation of a VIE by organizing the legal entity with nonsubstantive voting interests. Activities that involve or are conducted on behalf of the related parties of an investor with disproportionately few voting rights shall be treated as if they involve or are conducted on behalf of that investor. The term related parties in this paragraph refers to all parties identified in paragraph 810-10-25-43, except for de facto agents under paragraph 810-10-25-43(d)(1).
For purposes of applying this requirement, reporting entities shall consider each party’s obligations to absorb expected losses and rights to receive expected residual returns related to all of that party’s interests in the legal entity and not only to its equity investment at risk.

An entity is considered a VIE under this characteristic if both the following criteria are met:

□ Criterion 1: The voting rights of some investors are not proportional to their economic interest (i.e., obligations to absorb the entity’s expected losses and rights to expected residual returns).

□ Criterion 2: Substantially all of the entity’s activities either involve or are conducted on behalf of the investor(s) with disproportionately fewer voting rights.

This characteristic is intended to identify entities that are structured so that an entity can avoid consolidation under the voting interest model by providing nonsubstantive voting rights to another party. In essence, this provision is meant to catch potential abuses of the voting interest model (i.e., to avoid consolidation). This notion was emphasized by Eric Schuppenhauer of the SEC Staff at the 2003 AICPA National Conference on Current SEC Developments, where he stated:

_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._

### 4.2.3.1 Criterion 1: Disproportionate voting and economics

Under Criterion 1, each equity investor should be evaluated to determine whether its obligation to absorb the entity’s expected losses and/or receive the entity’s expected residual returns are in proportion to that investor’s voting rights. Characteristic 3 is different from the other four characteristics in that all variable interests held by the equity investors at risk must be considered, not just the voting rights and economics of each investor’s equity investment. The FASB has clarified that related parties and de facto agents should not be considered in the evaluation of Criterion 1, but should be considered in an evaluation of Criterion 2 (discussed further below).

We believe that for the purposes of examining the proportionality of the voting rights relative to the economics of the entity, these amounts do not necessarily need to be exactly equal. Judgment should be applied based on the facts and circumstances. Generally, the two amounts only need to be approximately the same to be considered proportional (e.g., 75 percent voting rights, which would result in control of the entity, and 80 percent economics). However, when the two amounts straddle 50 percent (i.e., 48 percent voting rights and 52 percent economics), the amounts should not be
considered proportional, regardless of the magnitude of the difference between the amounts—even 49.9 percent vote and 50.1 percent economics should be considered non-proportional. This conclusion is a result of the reporting entity’s possession of control, but not of a majority of the economics (or vice versa). In practice, joint ventures and partnerships frequently meet this criterion, as equity investors typically have other variable interests in the entity, which create economics that are disproportionate to voting rights.

Based on the literal wording, evaluation of this criterion would require a comparison of each participant’s variable interests to their voting interest, which would necessitate the determination of all expected losses and expected residual returns for the entity and for each participant. However, in some circumstances, detailed analyses may not be necessary. For example, if one party clearly has an economic participation of 60 percent or greater, but only has 50 percent of the vote, Criterion 1 would be met (i.e., the voting interests and economic interests would be disproportionate). Criterion 2 would then need to be evaluated to determine if the entity should be considered a VIE. Conversely, if one party has 50 percent of the vote and 40 percent of the equity, but also has a variable interest via a long-term purchase contract, a detailed calculation may be required to determine if the equity plus the purchase contract results in more than 50 percent of the entity’s expected losses and residual returns.

The determination of the level of voting rights may require considerable judgment, since, in many cases voting percentages are not defined by the underlying agreements. For example, many partnerships and limited liability companies do not define voting percentages. Rather, they operate under provisions whereby both parties must agree on all (or substantially all) of the major decisions (i.e., neither party has voting control). In such cases, we believe that the entity is under joint control, with both parties having 50 percent voting interests for the purposes of this characteristic, even though the percentages of legal ownership may be different. In essence, the focus should be on whether the governance of the entity would be substantively different if voting rights had been equal to economic rights.

To further understand the application of Criterion 1, consider the following examples:

**EXAMPLE 4-4**

Assume that Reporting Entity A holds a 65 percent equity interest in Entity 1 and that Reporting Entity B holds the remaining 35 percent equity interest. Each equity interest holder shares in the entity’s profits and losses in proportion to the holder’s equity investment. The governing documents include specific provisions granting Reporting Entity B rights that provide it with joint control over the substantive operating decisions of Entity 1 (i.e., voting rights). As a result, Reporting Entity A’s voting rights (i.e., 50 percent) are disproportionately low in relation to its exposure to the risks (i.e., 65 percent) and Criterion 1 is met. If Criterion 2 is met (i.e., substantially all of the entity’s activities either involve or are conducted on behalf of Reporting Entity A), Entity 1 would be considered a VIE.
Example 4-5

Assume that Reporting Entity ABC is an investor in Corporation X, holding 55 percent of the voting interests (and control of the entity) and 60 percent of the profits and losses of Corporation X. Although Reporting Entity ABC’s voting rights of 55 percent are not equal to its obligation to absorb the expected losses and receive the expected residual returns (i.e., 60 percent), control of the entity resides with Reporting Entity ABC because it holds a majority of Corporation X’s voting rights. In this scenario, the voting and economic interests would be proportional, since control resides with the investor that has the majority financial stake in the entity, even though the voting rights of the investors are not exactly equal to the investors’ economies.

Example 4-6

Assume that Company A and Company B each contributed $20 million in cash for 50 percent of the common stock in Corporation X (i.e., 50/50 ownership). In addition, Company A loaned $50 million to Corporation X in return for a note. Company A may therefore have two variable interests in Corporation X: (1) its equity investment and (2) its loan to Corporation X. In this scenario, Company A’s obligation to absorb the expected losses may be greater than its voting rights of 50 percent and if so, Criterion 1 will have been met with respect to disproportionate voting rights.

4.2.3.2 Criterion 2: Evaluating the “Substantially All” concept

For an entity to be considered a VIE with respect to this characteristic, Criterion 2 must also be met. Meeting this criterion requires substantially all of an entity’s activities to involve or to be conducted on behalf of the investor that has disproportionately few voting rights. We believe that an evaluation of whether this criterion has been fulfilled should be consistent with the evaluation performed under the business scope exception test, since the terminology is consistent (refer to VE 2.2.1 for discussion of the business scope exception).

As a general rule, we believe that this assessment is primarily qualitative. Some have suggested that the phrase substantially all should be interpreted to mean that 90 percent or more of the economics of the entity relate or accrue to the benefit of a particular party. We do not share this view. Rather, we believe that such a quantitative measure is only one of many factors that should be considered in evaluating this criterion. However, we recognize that there may be circumstances where the economics of the arrangement are so skewed in the direction of one reporting entity that a quantitative analysis may override other considerations in and of itself. We often use the following list of indicators in our evaluation (this is the same list of indicators that VE 2.2.1 includes):

<table>
<thead>
<tr>
<th>Strong indicators*</th>
<th>Other indicators*</th>
</tr>
</thead>
<tbody>
<tr>
<td>☐ The reporting entity sold assets to the entity in an effort to remove underperforming assets from the reporting entity’s balance sheet.</td>
<td>☐ The reporting entity sold assets to the entity.</td>
</tr>
<tr>
<td><strong>Strong indicators</strong>*</td>
<td><strong>Other indicators</strong>*</td>
</tr>
<tr>
<td>------------------------</td>
<td>----------------------</td>
</tr>
<tr>
<td>□ The entity’s major activities include selling substantially all of its products to the reporting entity under long-term contracts.</td>
<td>□ The entity’s major activities include selling a majority of its products to the reporting entity, and such relationship is expected to continue either because of long-term contracts or for other reasons.</td>
</tr>
<tr>
<td>□ The entity’s major activities include purchasing substantially all of its purchased products from the reporting entity.</td>
<td>□ The entity’s major activities include purchasing a majority of its purchased products from the reporting entity.</td>
</tr>
<tr>
<td>□ The reporting entity holds a non-reciprocal, fixed-price or “in the money” call option on the other investors’ equity investments, and/or the other investors have a fixed-price or “in the money” put option whereby they can put their investments to the reporting entity.</td>
<td>□ The reporting entity holds a non-reciprocal (or fair-value) call option on the other investors’ equity investments, and/or the other investors have a similarly priced, non-reciprocal put option.</td>
</tr>
<tr>
<td>□ The reporting entity is obligated to provide <strong>substantially</strong> all of any additional capital contributions that may be necessary to cover operating shortfalls.</td>
<td>□ The reporting entity is obligated to provide a <strong>majority</strong> of any additional capital contributions that may be necessary to cover operating shortfalls.</td>
</tr>
<tr>
<td>□ The entity performs research and development activities, and the reporting entity has an economic interest (e.g., through a purchase option) in the results of the research that constitutes <strong>substantially all</strong> of the entity’s activities.</td>
<td>□ The entity performs research and development activities, and the reporting entity is in a business that could capitalize on the results of the research that constitutes a <strong>majority</strong> of the entity’s activities.</td>
</tr>
<tr>
<td>□ The reporting entity has outsourced operations to the entity, constituting <strong>substantially all</strong> of the entity’s activities.</td>
<td>□ The reporting entity has outsourced to the entity operations that constitute a <strong>majority</strong> of the entity’s activities.</td>
</tr>
<tr>
<td>□ <strong>Substantially all</strong> of the entity’s assets are leased to the reporting entity.</td>
<td>□ A <strong>majority</strong> of the entity’s assets are leased to the reporting entity.</td>
</tr>
<tr>
<td>Strong indicators*</td>
<td>Other indicators*</td>
</tr>
<tr>
<td>--------------------</td>
<td>-------------------</td>
</tr>
<tr>
<td>□ The principal activity of the entity is to provide financing (e.g., loans or leases) to the reporting entity’s customers.</td>
<td>□ A majority of the entity’s activities involve providing financing (e.g., loans or leases) to the reporting entity’s customers.</td>
</tr>
<tr>
<td>□ The principal purpose of the entity is to conduct a business that is uniquely complementary to a significant business operation of the reporting entity and is not similar to activities of other participants in the entity.</td>
<td>□ The principal purpose of the entity is to conduct a business that is more closely related to a significant business operation of the reporting entity and only broadly similar to activities of one or more of the other participants in the entity.</td>
</tr>
<tr>
<td>□ The economics (e.g., capital at risk, participation in profits, etc.) are heavily skewed (e.g., close to 90 percent or greater) toward the reporting entity.</td>
<td>□ The economics (e.g., capital at risk, participation in profits, etc.) are weighted (e.g., greater than 60 percent) toward the reporting entity.</td>
</tr>
</tbody>
</table>

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

When evaluating whether substantially all of the activities either involve or are conducted on behalf of the investor that has disproportionately few voting rights, the investor must combine interests held by its related parties and de facto agents with its own interests (refer to VE 1.7 for a detailed description of related parties and de facto agents).

There are no broad “rules of thumb” that can be used to shortcut the evaluation required under Criterion 2. Instead, reporting entities will need to evaluate the relevant facts and circumstances surrounding each individual situation. Absent mitigating factors (e.g., indicators that point to a different conclusion), we believe that the presence of a single item from the “Strong Indicators” column may be sufficient to support a conclusion that substantially all of the activities of the entity either involve or are conducted on behalf of the reporting entity. At other times, multiple strong indicators may need to be present to reach the same conclusion. There are no “bright lines.” This assessment requires judgment. We also believe that the SEC shares this view as indicated by Eric Schuppenhauer of the SEC Staff at the December 2003 AICPA National Conference on Current SEC Developments, where he stated the following:

*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.*
If the reporting entity includes several of the “Other Indicators,” it may need to consider seriously whether or not the requirements of Criterion 2 have been met. In this instance, consultation with an accounting professional who is familiar with these provisions may be appropriate.

4.2.4 **Characteristic 4: Lacking the obligation to absorb an entity’s expected losses**

The VIE model indicates that an entity is considered a VIE if, as a group, the holders of the equity investment at risk lack the following:

**Excerpt from ASC 810-10-15-14(b)(2)**

The obligation to absorb the expected losses of the legal entity. The investor or investors do not have that obligation if they are directly or indirectly protected from the expected losses or are guaranteed a return by the legal entity itself or by other parties involved with the legal entity. See paragraphs 810-10-25-55 through 25-56 and Example 1 (see paragraph 810-10-55-42) for a discussion of expected losses.

The general principle underlying this characteristic is the need to identify equity interests that do not behave in a traditional manner. Many transactions are structured so that the party with the most significant exposure to an entity’s expected losses is not the equity investor(s).

Any assessment of whether the holders of the equity investment at risk possess this characteristic must be premised on a “first-dollar loss” concept. The reporting entity should determine whether the equity investors as a group are obligated to absorb the entity’s expected losses on a first-dollar basis until the equity is depleted (i.e., neither the entity itself nor other parties that are involved with the entity can protect the equity holders from the risk of loss on any portion of their investment). We believe that the FASB included this characteristic to identify entities designed to protect the group of equity investors from suffering expected losses caused by the predominant risks of the entity (not risks associated with unusual events) through arrangements or contracts that are associated with the entity that reside outside the equity at risk instruments. The FASB believes that when such protection exists, the traditional consolidation model (which is based on voting control) is ineffective. Therefore, the entity is considered a VIE and should be subject to the VIE model. This concept is illustrated in the excerpt below:

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

...If interests other than the equity investment at risk provide the holders of that investment with these characteristics or if interests other than the equity investment at risk prevent the equity holders from having these characteristics, the entity is a VIE.
4.2.4.1 How to evaluate this characteristic in practice

In making this evaluation, it is necessary to consider any contractual or monetary arrangement that may protect the equity investors at risk from absorbing a significant amount of the entity's expected losses (e.g., other variable interests) on a first dollar loss basis. In most cases, we expect that a qualitative assessment can be made about whether an entity’s expected losses are or are not fully absorbed by the group of equity at risk.

A guarantee generally would be considered a variable interest under the VIE model because a guarantee may absorb some portion of the entity’s expected losses. As a result, a reporting entity must determine whether the guarantee protects the equity investment at risk from absorbing the entity’s losses on a first-dollar basis up to the point at which the equity is depleted. Since debt guarantees are generally not called upon until the equity interests are depleted, such guarantees would not cause the entity to be a VIE with regard to this characteristic.

A residual value guarantee is provided by the lessee of the entity’s only asset. The residual value guarantee would be a variable interest (refer to VE 3 for discussion of variable interests). Typically, the residual value guarantee will protect the equity interests from any decline in the value of the leased asset and consequently will absorb losses prior to the equity. As a result, the existence of this guarantee would cause the entity to be considered a VIE with respect to this characteristic.

There is another consideration in applying this provision. The evaluation should focus only on the equity interests themselves, and not on the identity of the investor. For example, if an equity investor guarantees the value of an asset that the entity holds, even though the investor may have the economic obligation to absorb the entity’s first losses, the arrangement may result in the entity’s qualification as a VIE. This is because the obligation resides in the guarantee contract and is not inherent in the investor’s equity interest.

Disproportionate sharing of expected losses amongst equity investments at risk does not cause the entity to be considered a VIE under Characteristic 4 since it represents a mere sharing of expected losses amongst the group of equity investments at risk.

4.2.4.2 Impact of implicit variable interests

ASC 810-10-25-48 through 25-54 address if and when a reporting entity should consider whether it holds an implicit variable interest in a VIE or in a potential VIE. The existence of an implied variable interest may affect the determination of whether the potential VIE should be considered a VIE, particularly with respect to Characteristic 4. For example, if an implied variable interest exists that represents an implied guarantee of the only asset of an entity, the entity would be considered a VIE under Characteristic 4 since the equity investors at risk are protected by this implied variable interest. See VE 3 for a further discussion of implicit variable interests.
### 4.2.4.3 Additional examples: Evaluating an entity under characteristic 4

The following are additional examples, illustrating how to determine whether the entity in question is considered a VIE with regard to this characteristic:

**Insurance contracts**

Entities often enter into insurance arrangements to protect their assets from unforeseen events (e.g., fires, storms, etc.) or their businesses from unplanned interruptions. Applying Characteristic 4 to these contracts on a literal basis would cause many traditional companies to be considered VIEs. Based on discussions with the FASB, we understand that the intent of this characteristic pertains to risks that are an entity’s predominant risks and that are absorbed by non-equity interests as part of the conceptual design of the entity (i.e., risks that result in losses occurring in the normal course of business), not to risks that are related to unusual type events. Consequently, we do not believe that property and casualty insurance or business interruption insurance would cause an entity to be considered a VIE with respect to this characteristic.

**Total-return swaps**

Total-return swaps are an example of variable interests that generally would cause the entity to be a VIE with regard to this characteristic. If the total-return swap protects the equity investors at risk from expected losses on an entity’s assets, the entity would be considered a VIE.

**EXAMPLE 4-6**

Consider an entity that (1) issues debt of $250 and common stock of $50, and (2) acquires a bond with a fair value of $300. Assume that the entity enters into a total-return swap with an investment bank. The terms of the arrangement provide that the entity will pay 85 percent of the total return of the bond in exchange for a LIBOR-based return. If the asset’s value declines by one dollar, the investment bank will pay the entity 85 cents. The equity interests are protected from 85 percent of the asset’s losses. As a result, the entity would be deemed a VIE under this characteristic.

**Cost-plus sales contracts**

When evaluating whether an entity is a VIE with regard to this characteristic, there may be situations in which the equity interests are directly or indirectly protected from absorbing losses that are incurred by the entity’s customers. For example, a third-party customer might purchase goods or services from the entity at a price that would effectively cover all of the entity’s costs associated with those goods or services plus a fixed margin.

Such cost-plus arrangements *may* cause an entity to be a VIE under this characteristic, if they protect the equity investors from absorbing the entity’s expected losses. The determination is based on the facts and circumstances of the arrangement and requires an analysis of whether the contract serves to insulate the company from losses that it otherwise would incur. If the contract serves to eliminate variability in
the entity, the equity at risk interests would be protected and the entity would be considered a VIE.

*Other instruments that provide protection to the equity investment at risk*

Several other examples of variable interests in an entity that would cause an entity to be a VIE under Characteristic 4 are as follows:

- Guaranteed returns on an equity investment at risk by the entity itself or by other parties that are involved with the entity.

- Guarantees of the entity’s assets, only if the guarantee is a variable interest in the entity and not in specified assets (refer to VE 3 for discussion of variable interests in specified assets).

- A put option held by the entity (i.e., written by a reporting entity) or similar arrangement on the entity’s assets (if the fair value of the option’s underlying assets comprises more than 50 percent of the fair value of the entity’s total assets).

- A purchase agreement or option with a non-refundable deposit which can protect equity at risk from a portion of the market decline to the extent of the deposit.

4.2.5 **Characteristic 5: Lacking the right to receive an entity’s expected residual returns**

The VIE model indicates that an entity is considered a VIE if, as a group, the holders of the equity investment at risk lack the following:

**Excerpt from ASC 810-10-15-14(b)(3)**

The right to receive the expected residual returns of the legal entity. The investors do not have that right if their return is capped by the legal entity’s governing documents or arrangements with other variable interest holders or the legal entity. For this purpose, the return to equity investors is not considered to be capped by the existence of outstanding stock options, convertible debt, or similar interests because if the options in those instruments are exercised, the holders will become additional equity investors.

We believe that this characteristic is based on the principle that the investors that have equity interest at risk in a voting interest entity should have the rights to the entity’s residual profits. If the residual cash flows are shared or capped, the controlling financial interest in the entity may be held by persons other than the equity holders at risk. Therefore, an entity is considered a VIE in the following circumstances:

- The return to an equity investor at risk is capped.

- Other variable interest holders share in the residual cash flows at an amount that is considered significant relative to the level of expected residual returns (refer to
Determining whether an entity is a VIE

VE 3.3.9.3, VE 3.3.9.5 and VE 5.1.3 for a more detailed discussion of what may be considered significant).

We expect that in most cases, a qualitative assessment is sufficient for determining whether the equity investors at risk have the rights to the entity’s expected residual returns.

The evaluation should only focus on the equity ownership interests themselves, and not on the investors. For example, an equity investor may also hold participating debt that provides rights to a portion of the entity’s residual returns. Since that right resides in the participating debt agreement and is not inherent in the investor’s equity interest at risk, the entity may be considered a VIE if the participating debt participates in the residual profits at an amount that is large relative to the entity’s expected residual returns. We believe that this is what the FASB intended as illustrated in the excerpt below:

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

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

Disproportionate sharing of expected residual returns among equity investments at risk does not cause the entity to be considered a VIE under Characteristic 5, since it merely represents sharing of expected residual returns among the group of equity investments at risk.

4.2.5.1 Examples

There are many contracts that may or may not meet Characteristic 5. The following are some examples:

Call option on the entity’s assets

Assume that an entity writes a call option on its sole asset and therefore the call option is a variable interest in the entity (refer to VE 3 for a discussion of variable interests). We believe that such a call option may function as a cap to the equity investor’s right to receive residual profits. Whether the call option actually functions as a cap depends on the specific facts and circumstances. Relevant factors will include whether or not the option price is fixed, formula-based, or at fair market value. A call option with a fair market value price would not meet Characteristic 5, while a call option that is formula-based may or may not meet Characteristic 5.

Equity investments that are not considered “at risk”

In some situations, equity may be issued in return for the promise to provide services to the entity. Consider an entity that is capitalized with equity investments from two parties: Party A and Party B. Assume that Party A contributes cash for its 65 percent ownership interest and that Party B receives its 35 percent ownership interest in
return for services. Further assume that all cash flows are distributed among the parties in accordance with their ownership percentages. The equity held by Party B would most likely not be considered at risk. Since Party B participates in the entity's expected residual returns, Characteristic 5 may be present, and if so the entity would be considered a VIE.

*Other contracts tied to an entity’s performance*

Many operating entities have contracts that allow for some sharing in the entity’s expected residual returns. We believe that the following types of contracts should be considered in making this assessment assuming that they are variable interests (see VE 3 for a discussion on variable interests):

- Service contracts that are indexed to the entity’s performance.
- Decision maker fees.
- License, royalty and other similar arrangements.

We believe that in an assessment of these contractual agreements, profits should be interpreted more broadly, and not limited to items such as net income or earnings before taxes. Other performance measures (e.g., revenue, operating income, EBITDA) should also be considered. However, only those arrangements that share in amounts that are large relative to the level of expected residual returns would result in the presence of this characteristic. In most entities, these contracts would not cause the entity to be considered a VIE with respect to this characteristic. However, in assessing this characteristic, the reporting entity should evaluate the terms of each contract and the entity’s level of sharing in the entity’s returns.

**4.3 Reconsideration events: VIE status**

Simply determining whether an entity is a VIE at its creation or at the reporting entity’s first date of involvement with the entity is considered insufficient practice. Certain events may occur that would require a reporting entity to re-evaluate whether or not an entity is, in fact, a VIE. In the VIE model, the FASB lists specific events that would require the reconsideration of an entity’s VIE status as follows:

**Excerpt from ASC 810-10-35-4**

A legal entity that previously was not subject to the Variable Interest Entities Subsections shall not become subject to them simply because of losses in excess of its expected losses that reduce the equity investment. The initial determination of whether a legal entity is a VIE shall be reconsidered if any of the following occur:

- The legal entity’s governing documents or contractual arrangements are changed in a manner that changes the characteristics or adequacy of the legal entity’s equity investment at risk.
b. The equity investment or some part thereof is returned to the equity investors, and other interests become exposed to expected losses of the legal entity.

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

d. The legal entity receives an additional equity investment that is at risk, or the legal entity curtails or modifies its activities in a way that decreases its expected losses.

e. Changes in facts and circumstances occur such that the holders of the equity investment at risk, as a group, lose the power from voting rights or similar rights of those investments to direct the activities of the entity that most significantly impact the entity’s economic performance.

A reporting entity must re-evaluate whether or not an entity is a VIE upon the occurrence of one of the reconsideration events only if the event is significant. Generally speaking, if the reporting entity concludes that the VIE status of the entity would change upon the occurrence of one of these events, the event would be considered significant enough to merit reconsideration under the VIE model.

Note that the VIE model as amended by ASU 2009-17 removed the exception for troubled debt restructurings as a VIE reconsideration event. Previously troubled debt restructurings were exempted from triggering a reconsideration event because ASC 310-40, Receivables—Troubled Debt Restructurings by Creditors (ASC 310-40) and ASC 470-60, Debt—Troubled Debt Restructurings by Debtors (ASC 470-60) were essentially the only accounting guidance for debtors and creditors. However, any debt restructuring that did not qualify as a troubled debt restructuring was evaluated to determine whether it represented a reconsideration event under the VIE model. Now a troubled debt restructuring is no longer exempt from being a reconsideration event. The FASB’s removal of the troubled debt restructuring exemption may significantly impact banks and other lenders. In most instances, if the entity becomes a VIE upon a troubled debt restructuring, banks/lenders may conclude that they are not the primary beneficiary, however, they may become subject to the disclosure requirements (see VE 7 for a discussion about disclosure requirements).

### 4.3.1 Reassessment of the design of an entity upon a reconsideration event

As discussed in VE 3, ASC 810-10-25-21 through 25-36 provides guidance regarding how an entity’s design should be evaluated to determine the nature of the entity’s variability for the purposes of evaluating the entity under the VIE model. The guidance must be considered upon the occurrence of any reconsideration event described in the VIE model. This might require a reporting entity to consider in its VIE assessment new or different risks (e.g., interest rate risk) that face the entity.

The following sections discuss each of the reconsideration events described in the VIE model in detail.
4.3.2 *Losses that reduce the equity investment*

**Excerpt from ASC 810-10-35-4**

A legal entity that previously was not subject to the Variable Interest Entities Subsections shall not become subject to them simply because of losses in excess of its expected losses that reduce the equity investment.

The first concept discussed is the notion that operating losses in excess of the expected losses that reduce the equity investment will not trigger a reconsideration of an entity’s VIE status. The rationale behind this concept seems to focus on the design of the entity. Merely incurring operating losses does not affect the characteristics of the equity investment at risk or the relationship among the equity investors at risk and other variable interest holders. If the equity at risk was deemed sufficient in the initial analysis of the VIE, and no events that could be considered a “redesign” of the entity have occurred (such as the events included above), there would be no basis to conclude that the entity has become a VIE, just because it has incurred losses. It should be noted, however, that if one of the reconsideration events does occur, the entity’s VIE status will need to be re-evaluated as of that date, and a prior history of operating losses that have reduced the equity investment at risk will need to be considered as part of that analysis. Note that irrespective of whether or not a VIE reconsideration event has occurred, the primary beneficiary analysis is required to be carried out every reporting period by the reporting entity if such reporting entity has a variable interest in a VIE (see VE 5.1.1 for details).

4.3.3 *Change in governing documents or contractual arrangements*

**Excerpt from ASC 810-10-35-4(a)**

The legal entity’s governing documents or contractual arrangements are changed in a manner that changes the characteristics or adequacy of the legal entity’s equity investment at risk.

This reconsideration event focuses on the redesign or restructuring of an entity’s governing documents or contractual arrangements among the parties involved with the entity. The clarifying phrase *that changes the characteristics or adequacy of the entity’s equity investment at risk* will help preparers and auditors determine whether a change in these documents/arrangements would trigger a reconsideration of the entity’s VIE status. Only significant modifications that affect the characteristics or adequacy of the entity’s equity investment at risk would be considered reconsideration events.
Determining whether an entity is a VIE

Changes in the characteristics of the entity’s equity investment at risk

It will be easier to determine whether a modification of the governing documents or contractual arrangements affects the characteristics of the entity’s equity investment at risk than to determine changes to its adequacy. Consider a situation where the equity investors at risk in a VIE cede certain voting rights to another variable interest holder. The reporting entity (investor) would need to contemplate whether the modifications in the governing documents were significant and whether or not those modifications changed the characteristics of the equity investment. In this example, the following two factors may be considered by the reporting entity to assess whether a reconsideration event has occurred:

1. Consider whether the rights ceded to the other variable interest holders were participating or protective rights.

2. Consider whether the entity’s VIE status would change if this event was considered a reconsideration event. (i.e., was the modification so significant that the entity would now be considered a VIE?)

If the modification is significant and changes the characteristics of the entity’s equity investment at risk, it would be deemed a reconsideration event under the VIE model.

Changes in adequacy of the entity’s equity investment at risk

Determining whether or not a modification of the governing documents or contractual arrangements affects the adequacy of the entity’s equity investment at risk will be more difficult. This difficulty arises from the need to determine what caused the change in the adequacy of the equity investment at risk and whether equity at risk investors as a group lost the power over the entity. Only significant modifications that directly impact the adequacy of the equity investment at risk or cause the equity at risk investors as a group to lose power over the entity would be considered triggering events under the VIE model.

<table>
<thead>
<tr>
<th>Immediately before modification</th>
<th>Immediately after modification</th>
<th>Reconsideration event?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sufficient equity</td>
<td>Insufficient equity</td>
<td>Yes</td>
</tr>
<tr>
<td>Insufficient equity</td>
<td>Sufficient equity</td>
<td>Yes</td>
</tr>
<tr>
<td>Insufficient equity</td>
<td>Insufficient equity</td>
<td>No</td>
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</tbody>
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Immediately before modification: Sufficient equity and the equity at risk investors as a group continue to hold power over the entity.
In the table above, the notions of sufficient and insufficient equity refer to whether or not the entity qualifies as a VIE under Characteristic 1: Insufficient Equity Investment at Risk. Sufficient equity indicates that the entity would not possess Characteristic 1, while insufficient equity indicates that the entity would possess this characteristic. By evaluating the sufficiency of the equity immediately before and immediately after the modification and whether equity at risk investors as a group lost power over the entity, the reporting entity can assess the effect of that modification on the adequacy of the equity without the impact of prior operating losses.

4.3.4 Return of investment to equity investors

Excerpt from ASC 810-10-35-4(b)

The equity investment or some part thereof is returned to the equity investors, and other interests become exposed to expected losses of the legal entity.

A return of equity investment (that qualifies as equity at risk) to the investor would also constitute a redesign of the entity. Since one of the five characteristics of a VIE focuses on the sufficiency of the equity at risk, a reduction in that amount would generally trigger a reconsideration event that pertains to an entity’s VIE status. Although a reduction in the equity investment caused by operating losses would not indicate that redesign of the entity has occurred, a return of some or all of an equity investment to the investor(s) would indicate that a redesign has occurred, as long as other interests have become exposed to the entity’s expected losses. Again, the reporting entity should consider whether or not the return of the equity investment is significant before concluding that the reduction constitutes a reconsideration event. This reconsideration event (i.e., return of investment to equity investors) is intended to focus on situations in which a voting interest entity may become a VIE.

EXAMPLE 4-8

Consider an entity that was capitalized with 85 percent debt and 15 percent equity on a fair value basis at formation date. The reporting entity concluded that the equity investment at risk was sufficient such that the entity was not a VIE with respect to Characteristic 1: Insufficient Equity Investment at Risk at the time it made the investment. Suppose that six months later the entity returns a portion of the equity investment to the investor (the investor is also the reporting entity) and consequently causes the new capital structure to become 99 percent debt and 1 percent equity on a fair value basis at recapitalization date. Since this return of capital causes the debt to be exposed to additional expected losses, the reporting entity should re-evaluate the entity’s VIE status.
Entity undertakes additional activities

Excerpt from ASC 810-10-35-4(c)

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

This reconsideration event is also intended to focus on situations in which a voting interest entity (not previously subject to consolidation under the VIE model) may become a VIE. When analyzing this reconsideration event, consider whether there has been a redesign of the entity. During the initial VIE analysis, the reporting entity is required to assess the sufficiency of the equity investment at risk by evaluating the entity’s current and anticipated activities and by determining the equity amounts needed (either quantitatively or qualitatively) to finance those activities. In a quantitative analysis, that assessment would involve calculating the expected losses of the entity—a calculation that would be derived from the variability or risk associated with the current and anticipated future activities of the entity. This reconsideration event suggests that if the reporting entity had anticipated the undertaking of new activities or the acquisition of additional assets in its initial assessment under the VIE model, the actual undertaking or acquisition itself would not be considered a reconsideration event. Only an undertaking/acquisition that was not anticipated at the date of the original analysis would trigger reconsideration under this provision.

The reconsideration event focuses on whether or not the unanticipated activities or newly acquired assets actually increase the entity’s expected losses. Consider the following example:

EXAMPLE 4-9

Assume that an entity holds two financial assets, one share of stock in a “Blue Chip” utility company and one share of stock in a “high-tech” start-up company. At the entity’s inception, the reporting entity determined that the entity was not a VIE. Six months later, the entity sells its share of stock in the utility company and buys an additional interest in the start-up company. If the acquisition of this new asset was not anticipated at the entity’s inception and the entity’s expected losses have increased (as a result of the increased risk), it would be considered a reconsideration event. Now suppose that the entity sold its share of stock in the start-up company and bought an additional share in the utility company. If the portfolio of assets has become less risky, thus decreasing the expected losses of the entity, the acquisition of the new asset would not be considered a triggering event under the VIE model.

We believe that the difficult task of assessing whether the acquisition of additional assets or the undertaking of additional activities constitutes a reconsideration event will often be driven by specific facts and circumstances, and will depend heavily on the entity’s current business activities (e.g., an operating joint venture versus an SPE that holds financial assets). We believe that the threshold for concluding that a reconsideration event has occurred will be higher for an operating joint venture than an SPE. In those situations, the reporting entity should consider whether the
acquisition/undertaking represents a significant change in the business activities of the entity. When a reporting entity evaluates whether a reconsideration event has occurred in an SPE that holds financial assets, the reporting entity should emphasize the significance of new acquisitions/undertakings relative to the current portfolio of the SPE’s assets, including changes in the volatility or risk of the overall portfolio resulting from the new acquisitions/undertakings.

4.3.6 **Entity receives additional equity investment or decreases expected losses**

Excerpt from ASC 810-10-35-4(d)
The legal entity receives an additional equity investment that is at risk, or the legal entity curtails or modifies its activities in a way that decreases its expected losses.

Although this reconsideration event may initially appear to be the inverse of the events described in VE 4.3.4 and VE 4.3.5, it is not. The previous two reconsideration events are focused on events that may cause a voting interest entity to become a VIE. However, the FASB acknowledged that there may be situations in which a VIE could become a voting interest entity. This reconsideration event considers those situations in which an entity receives additional equity investment that potentially increases the sufficiency of the equity at risk. Additionally, if the entity modifies its activities in a way that decreases its expected losses, an equity investment once deemed insufficient may become sufficient under Characteristic 1: Insufficient Equity Investment at Risk. However, this is not the only possible outcome; a “recapitalization” of an entity may cause it to become a VIE.

4.3.7 **Holders of equity investment at risk lose power**

Excerpt from ASC 810-10-35-4(e)
Changes in facts and circumstances occur such that the holders of the equity investment at risk, as a group, lose the power from voting rights or similar rights of those investments to direct the activities of the entity that most significantly impact the entity’s economic performance.

Under the VIE model, an entity will become a VIE if, as a result of changes in facts and circumstances, its holders of equity investment at risk lose the power through voting or similar rights to direct the activities of the entity that most significantly impact its economic performance. The FASB included this reconsideration event to capture situations in which the equity investors at risk lost power over the entity which may not have been a reconsideration event under the previous requirements. For example, they were troubled by the lack of reconsideration under the previous VIE model for circumstances in which an entity suffered from severe losses such that the holders of the equity investment at risk as a group lost the power to direct the activities of the entity that most significantly impact its economic performance.
4.3.8 Bankruptcy

Generally, when an entity files for bankruptcy, the equity at risk holders as a group lose the power to make decisions that have a significant impact on the economic performance of the entity because this decision making would typically transfer to the bankruptcy court. Therefore, we believe that the act of filing for bankruptcy typically constitutes a reconsideration event under the VIE model. Note that the primary beneficiary analysis is required to be carried out every reporting period by the reporting entity if such reporting entity has a variable interest in a VIE (see VE 5.1.1 for details).

4.3.9 Decision maker or service provider arrangements

As discussed in VE 3.3.9.6, the VIE model does not specify reconsideration of whether or not a decision maker or service provider arrangement is a variable interest should be based on reconsideration events or should be carried out on a continuous basis. We believe that reconsideration of whether or not a decision maker or service provider arrangement is a variable interest is a policy choice (see Question 3.2). If such arrangements are evaluated on a continuous basis, changes in the determination can impact all of the reconsiderations events described above.

4.4 Questions and interpretive responses

Identifying the holders of the equity investment at risk

Question 4-1

Does a hybrid equity instrument that contains an embedded derivative requiring bifurcation pursuant to the provisions of ASC 815-15-25, qualify as part of the total equity investment at risk?

PwC response

The embedded derivative that must be separated from the host contract per the provisions of ASC 815-15-25 must be classified as an asset or liability and thus would be excluded from the assessment of the total equity investment at risk. However, the value ascribed to the host contract that would be accounted for in GAAP equity might qualify for inclusion in the assessment of the total equity investment at risk, assuming that the host contract meets the other requirements of qualifying as equity investment at risk. Specifically, one must determine whether the host contract meets the requirement to participate significantly in profits and losses with other equity investors at risk. That requirement would not be met, for example, if the separated derivative were a fixed price put option that was determined to protect the host contract’s investor from expected losses of the entity.
Question 4-2

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

Would this “sweat equity” meet the criteria for being included in the equity investment at risk?

PwC response

No. Consistent with the conclusion in SAB 103, Topic 1.1 (originally concluded upon in the AICPA’s February 1986 notice to practitioners entitled ADC Arrangements and subsequently reprinted without modification as exhibit I of the AICPA’s Practice Bulletin 1, dated November 1987), sweat equity is not considered at risk for the purposes of determining the equity investment at risk. In effect, sweat equity is financed for the equity holder by the entity itself. The VIE model specifically precludes such amounts from being considered part of the equity investment at risk for the purposes of determining whether there is sufficient equity at risk in the entity. Therefore, the equity holder that received the sweat equity would not be included in the “group” of equity investors at risk for purposes of evaluating the characteristics of qualifying for equity investment at risk. As a result, in an evaluation of whether the “group” of holders of the equity investment at risk has the characteristics of a controlling financial interest, Characteristic 2: Equity Lacks Decision Making Rights, would potentially be met if the equity holder that received sweat equity also received voting shares. Similarly, Characteristic 4: Lacking the Obligation to Absorb an Entity’s Expected Losses would be potentially met because the equity holder that received sweat equity shares would have a right to the expected residual returns of the entity.

Question 4-3

Company A is occasionally included in legal actions alleging that it has infringed patents. Company A expects the volume of these claims to increase as its business grows. As a result, the Company obtains a 49.5 percent limited partnership interest in a private-equity fund (the “PEF”), which effectively operates like a “patent troll” (i.e., it uses invested funds to acquire patents in certain industries and then seeks license fees by enforcing these patents).

In order to obtain the limited partnership interest, Company A paid $4 million, which included an upfront license fee. The upfront license fee was $2.4 million and the terms of the partnership agreement call for the license fee to be immediately distributed to the PEF’s limited partners (including Company A) based on their ownership interests (with the amount being limited to each partners’ capital contribution amount). These fees would be considered unconditional in nature.

Company A is assessing the impact of the VIE model on this transaction. How does the distribution of the upfront license fee impact the calculation of the equity at risk?
**PwC response**

The VIE model states that equity investment at risk does not include amounts provided to the equity investor directly or indirectly by entity or other parties involved with the entity. Generally, fees that are paid concurrent with the formation of an entity (or shortly thereafter) and are unconditional in nature would be considered a return of the amounts invested by the equity investors. Therefore, the distribution of the upfront license fees would result in a reduction of equity investment at risk for both Company A and the other parties in the limited partnership.

**Question 4-4**

The general partner of a limited partnership investment fund makes no initial cash contribution to the partnership interest but has the right to elect that investment management fees earned in the future be allocated to its partnership interest. The following two questions arise, assuming that the entity is a VIE due to meeting Characteristic 2: Equity Lacks Decision Making Rights on day 1:

1. As fees are earned, will the fair value of the general partner’s equity interest qualify as equity at risk under Characteristic 1: Insufficient Equity Investment at Risk?
2. If so, does the general partner’s earning of management fees paid to its partnership interest qualify as a reconsideration event under the VIE model?

**PwC response**

**Answer 1:** Investment management fees earned and allocated by the general partner to its equity interest will be considered equity at risk whenever the following conditions are met:

i. The fees are commensurate with the fair value of the service rendered; and

ii. If

a. the general partner has the right to elect cash or have its fee allocated to its equity interest, the services provided are substantive and the fees are conditional upon the performance of the general partner (i.e., fees are not earned unless prescribed duties are carried out to the satisfaction of the limited partners); or

b. the general partner does not have the right to elect cash and its fee is allocated to its equity interest, the limited partners by simple majority vote hold substantive kick-out rights with respect to removing the general partner. If the limited partners do not have substantive kick-out rights exercisable by simple majority vote, the fees earned by the general partner would be considered unconditional and therefore not equity at risk.

If the foregoing conditions are met, the allocation of fees earned should be considered the same as if the fees were paid out in cash and then re-invested by the general partner into the limited partnership fund.
Answer 2: Yes, if the fees are considered to be equity at risk, the reallocation of capital between the limited partners and the general partner with respect to investment management fees earned represents the infusion of equity capital into the entity and will result in a reconsideration event under the VIE model, unless the reconsideration event is insignificant. At the date on which the allocated fees represent an amount that will participate significantly in the profits and losses of the entity, the general partner’s equity interest will be considered at risk. Refer to VE 4.3 for a discussion of reconsideration events.

Characteristic 1: Insufficient equity investment at risk

Question 4-5

The VIE model lays down three conditions to determine whether equity at risk is sufficient when neither a qualitative assessment nor qualitative assessment when taken alone is conclusive (see VE 4.2.1.2 and VE 4.2.1.3 for details). In practice, how should one demonstrate the three conditions in the sufficiency of equity at risk test with respect to overcoming the presumption that an equity investment of less than 10 percent is insufficient?

PwC response

To demonstrate one of the three conditions in the sufficiency of equity at risk test, each individual equity investment must meet all the criteria to qualify as equity investment at risk to be considered part of the total equity investment at risk. After one has identified the equity investment that is considered “at risk,” one or all three conditions in the sufficiency of equity at risk test can be utilized to demonstrate that the “at risk” equity is sufficient. However, we believe that it may be difficult for many entities to demonstrate the circumstances specified in the three criteria.

Ability to finance activities without additional subordinated financial support: The FASB staff believes that entities which have issued investment-grade senior debt may be able to demonstrate that the entity can finance its operations without additional subordinated financial support (i.e., the entity has been able to obtain financing that is low-risk, with an interest rate that is commensurate with those low-risk activities). The FASB staff also indicated that there may be certain circumstances in which the entity can demonstrate that it has sufficient equity, even if the entity has issued subordinated debt that is also investment grade. However, the grade and related interest rate of the subordinated debt must be evaluated to determine whether it is comparable with what is typical for low-risk investments. Depending on the nature and grade of the entity’s debt and other financing, the entity may not necessarily demonstrate the sufficient equity at risk condition, even if it has diversified assets and risks.

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: It may be difficult to find another entity (1) with assets that are similar in quality and located in similar amounts and (2) without additional subordinated financings in its capital structure. For this reason, it will be difficult to demonstrate this condition.
Determining whether an entity is a VIE

**Amount if equity invested in the entity exceeds the entity’s estimated expected losses based on reasonable quantitative evidence:** If the above two conditions cannot be evaluated, only the last criterion can be used as a basis for concluding that an equity investment of less than 10 percent is adequate (i.e., that the equity exceeds the expected losses of the entity). Assessing whether the last criterion can be demonstrated could necessitate a complex and time-consuming effort, particularly for operating entities, since they would have to project operating results and cash flows well into the future. Further, this criterion requires that the estimate of the entity’s expected losses be “based on reasonable quantitative evidence.” Entities lacking reliable information will be unable to fulfill that criterion.

Finally, the ability to demonstrate any one of the three conditions does not automatically indicate that the entity is not a VIE. There are four other requirements that must be evaluated before one can determine whether the entity is a VIE.

**Question 4-6**

In determining whether a development-stage enterprise has sufficient equity, what is meant by the phrase “the activities it (the development stage enterprise) is currently engaged in?”

**PwC response**

Based on discussions with a FASB member, and as clarified in the FASB’s discussions during deliberation of the guidance, it is our understanding that the Board did not intend for the guidance regarding development-stage entities to be interpreted as a scope exception. Rather, the Board intended to provide guidance on how the concepts of the VIE model should be applied in the unique circumstances surrounding such entities. This exception applies only to the sufficiency of equity at risk criterion. As a result, all other characteristics of a VIE must also be assessed to determine whether an entity is a VIE. Many development-stage entities go through several phases of existence before they are considered substantive operating entities. For example, the phases of a pharmaceutical research-and-development entity might be divided into milestones, such as initial research, clinical trials, FDA approval, etc. Consequently, a key question arises: Should the expected losses and expected residual returns be estimated based on the development-stage entity’s current phase only or on its entire life cycle?

When evaluating a development-stage entity, only the current phase of development (i.e., the phase for which financing has already been obtained) should be considered. Thus, in order for entities in the development stage to avoid being considered VIEs, the entity must have equity that is sufficient to permit it to finance the activities in its current phase (i.e., the activity in which the entity is currently engaged). Additionally, provisions in its governing documents must enable the entity to obtain additional equity capital that will allow it to finance future phases. Thus, some development stage entities may be VIEs and have to be consolidated by another party if the entity’s governing documents do not provide for additional equity investments in subsequent phases.
**Characteristic 2: Equity lacks decision making rights**

**Question 4-7**

At the formation of a limited partnership (the Partnership), it was determined that the general partner (GP) made a non-substantive equity investment in the Partnership. Additionally, the GP holds all substantive decision making rights in the Partnership and the limited partners do not hold any ability to remove the GP. However, related parties of the GP made substantive limited partner investment in the Partnership. It was determined, based on the guidance in VE 4.2.2.5, that the economic interest held by the related parties of the GP should be combined with the controlling interest of the GP. The combination of those interests did not result in the entity being a VIE under Characteristic 2 and the Partnership was considered a voting interest entity, as no other characteristics of a VIE in the VIE model were met.

Subsequently, the related parties sold their economic interest in the Partnership to an unrelated third-party.

Should the related parties’ subsequent sale of their economic interest cause the GP’s equity to be no longer considered “at risk” and result in the Partnership becoming a VIE?

**PwC response**

The partial sale of the interest would not in and of itself cause the GP to reconsider whether or not the Partnership is a VIE under the VIE model. We believe that the initial combination of the GP’s controlling interest and the related parties’ economic interest should be viewed as one interest in the Partnership for evaluation of whether or not the entity is a VIE. Given that at inception the combined interest was determined to be equity at risk for evaluation under the VIE model, the remaining portion of that interest after the partial sale would continue to be considered equity at risk. Effectively, the remaining GP interest would be considered equity at risk.

**Characteristic 3: Equity with nonsubstantive voting rights**

**Question 4-8**

Consider a reporting entity whose economic interest in an entity is greater than its voting interest in the same entity. Is the disproportionate voting interest and economic interest criterion met if the voting interest held by that reporting entity would not be substantively different if those voting rights were proportionate to its economic rights?

**PwC response**

The disproportionate voting interest and economic interest criterion was included to identify entities designed with nonsubstantive voting rights and to subject those entities to the economic risk and rewards model established in the VIE model. In situations where a technical disproportionality exists, it is not automatically assumed that the disproportionate voting interest and economic interest criterion is met. Rather, the focus should be on whether the governance of the entity would be substantially different had voting rights been equal to economic rights.
For example, if an entity had 25 percent of the economic risks and rewards of an entity, but held only 15 percent of the voting rights (as determined through review of the investors’ ability to vote on the substantive operating decisions of the entity), whether the investor would be able to participate in additional substantive operating decisions through voting or veto rights at the 25 percent voting level should be considered. If the investor would not have any additional rights at the increased voting percentage, no substantive disproportionality would be assumed under the disproportionate voting interest and economic interest criterion. However, when the two amounts straddle 50 percent (i.e., 48 percent voting rights and 52 percent economics), the amounts should not be considered proportional, regardless of the magnitude of the difference between the amounts—even 49.9 percent vote and 50.1 percent economics should be considered non-proportional. If additional voting or veto rights would be achieved at the increased level, whether the investor meets the “substantially all” criterion should be considered.

**Characteristic 4: Equity lacks the obligation to receive an entity’s expected losses**

**Question 4-9**

Company A (reporting entity) enters into a purchase and sale agreement with Company X (entity) under which Company A will buy from Company X and Company X will sell to Company A land and building. Company X’s sole asset is the land and building under the agreement. As part of the agreement, Company A is required to pay a non-refundable deposit to Company X. Company A also has the right to terminate the contract, subject to the loss of its deposit. Assuming that Company A has a variable interest in Company X due to the purchase and sale agreement (see Example 3-6 for details), will Company X be considered to be a VIE?

**PwC response**

Yes. In the fact pattern in this example, the purchase and sale agreement of real estate requires Company A (buyer) to make a non-refundable deposit to Company X (seller) where Company X’s sole asset is the real estate subject to the agreement. The non-refundable deposit absorbs some of the Company X’s variability and transfers to the buyer some of the usual risks and rewards of ownership. In essence, the protection provided to the seller from the non-refundable deposit would cause Company X to be a VIE under ASC 810-15-14(b)(2) because the non-refundable deposit absorbs significant variability in the entity by providing protection to the equity holders of Company X from first dollar losses with respect to changes in value of the underlying asset.
**Characteristic 5: Equity lacks the right to receive an entity’s expected residual returns**

**Question 4-10**

A JV is created, whereby Company A and Company B each contributes $50 million in cash to the JV in exchange for a 50 percent equity ownership in the JV. The JV’s board of directors consists of 4 directors. Company A and Company B each has equal representation on the board and decisions require a unanimous vote. Company A has an option to purchase Company B’s equity interest in the JV for $60 million 2 years from the JV inception date. Assume that the option to purchase Company B’s equity interest is a variable interest at inception under the VIE model because (a) it is a fixed price option and Company A absorbs the positive variability from the change in the fair value of the JV; and (b) there are no significant barriers for Company A to exercise the option. Does the option cause the JV to be a VIE?

**PwC response**

Yes. If the option is determined to be a variable interest that is not embedded in the equity, (e.g., Company A and/or Company B’s shares can be transferred without the transfer of the option), then it is likely that the JV may be a VIE if the option holder is able to acquire more than 50 percent of the equity interest in the JV upon exercise. This is because the equity holders at risk may not have the right to receive the expected residual returns of the JV because the option holder would be in a position to absorb positive variability through the exercise of the option. However, if the option is determined to be embedded in the equity interest, (e.g., Company A and/or Company B’s shares cannot be transferred without the transfer of the option), then the JV will not be a VIE.

**Reconsideration events: VIE status**

**Question 4-11**

The VIE model requires that reporting entities initially determine whether an entity is a VIE at the date on which they became involved with that entity. Would future changes in GAAP affecting the classification of instruments be considered triggering events under the VIE model? If so, would they necessitate a reassessment of the entity’s VIE status?

**PwC response**

No. We believe that a change in GAAP is not a triggering event under the VIE model and therefore we believe that such a change in GAAP would not require a reconsideration of the entity’s VIE status. However, if other events that qualify as triggering events (as described in the VIE model) occur and a reporting entity is required to re-evaluate whether an entity is a VIE, any changes in GAAP that occurred since the last triggering event must be considered.
Question 4-12

Similar fact pattern as in Question 4-10 above except that Company A’s deposit is a conditionally refundable deposit. The purchase and sale agreement states that Company A is obligated to purchase the land and building only if (i) Company X gets the zoning for the property changed; or (ii) Company X obtains written consent from its lenders permitting Company A to assume existing non-recourse debt encumbering the property. There is a time limit on the resolution of the contingencies and if the contingencies are met, Company A must either purchase the land and building or forfeit the deposit. Should the purchase and sale agreement be re-evaluated if and when the contingencies are met?

PwC response

Generally yes. In the circumstances described above, if the contingencies were met (i.e., zoning approval obtained or lender approval received) and no remaining contingencies existed, a reconsideration event may have occurred. The deposit should then be viewed as a non-refundable deposit and re-evaluated per Question 4-10 above.
Chapter 5: Identifying the primary beneficiary of a VIE
Identifying the primary beneficiary of a VIE

Executive takeaway

- The primary beneficiary is the reporting entity that is required to consolidate the VIE.

- The VIE model is predominantly a qualitative model for determining which entity has a controlling financial interest and is the primary beneficiary of a VIE. However, for VIEs subject to the deferral of ASU 2010-10, the primary beneficiary analysis is based upon absorption of a majority of expected risks and rewards.

- The primary beneficiary is the variable interest holder that has (1) the power to direct activities that most significantly impact the economic performance of the VIE, and (2) the obligation to absorb losses or the right to receive benefits of the VIE that could potentially be significant to the VIE.

- Individual parties within a related party group (including de facto agents) should first separately consider whether any party within the related party group is the primary beneficiary on a stand-alone basis (which may frequently be the case). If no party within the related party group is the primary beneficiary on a stand-alone basis, the determination of the primary beneficiary within such group is based on an analysis of the facts and circumstances with the objective of determining which party is most closely associated with the VIE (i.e., the related party tiebreaker).

- A reporting entity is required to reconsider whether it is the primary beneficiary of a VIE on an ongoing basis.
5.1 Identification of the primary beneficiary

Once a reporting entity determines that it has a variable interest in a variable interest entity (VIE), it must determine whether or not it is the primary beneficiary and should consolidate the VIE.

5.1.1 What is a primary beneficiary?

A primary beneficiary (PB) is the reporting entity that is required to consolidate the VIE. The VIE model requires a reporting entity with a variable interest in a VIE to qualitatively (and not quantitatively) assess whether it has a controlling financial interest in the entity and, if so, whether it is the primary beneficiary. In other words, a majority share of risks and rewards is not required to be the primary beneficiary. The approach is intended to encourage the use of judgment in determining which reporting entity controls a VIE.

Excerpt from ASC 810-10-25

38A: A reporting entity shall be deemed to have a controlling financial interest in a VIE if it has both of the following characteristics:

a. The power to direct the activities of a VIE that most significantly impact the VIE’s economic performance

b. The obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE. The quantitative approach described in the definitions of the terms expected losses, expected residual returns, and expected variability, is not required and shall not be the sole determinant as to whether a reporting entity has these obligations or rights.

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

38B: A reporting entity must identify which activities most significantly impact the VIE’s economic performance and determine whether it has the power to direct those activities. A reporting entity’s ability to direct the activities of an entity when circumstances arise or events happen constitutes power if that ability relates to the activities that most significantly impact the economic performance of the VIE. A reporting entity does not have to exercise its power in order to have power to direct the activities of a VIE.
The reporting entity is deemed to be the primary beneficiary if it meets both criteria below:

- **Power Criterion**: Power to direct activities of the VIE that most significantly impact the VIE’s economic performance ("power criterion").

- **Losses/Benefits Criterion**: Obligation to absorb losses from or the right to receive benefits of the VIE that could potentially be significant to the VIE ("losses/benefits criterion").

In assessing whether a reporting entity has both the power criterion and the losses/benefits criterion in an entity, it should consider the entity’s purpose and design, including the risks that the entity was designed to create and pass through to its variable interest holders.

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 meet the losses/benefits criterion, only one reporting entity (if any) will have the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance.

The VIE model calls for increased skepticism in situations where a reporting entity’s economic interest in a VIE is disproportionately greater than its stated power to direct the activities of a VIE that most significantly impact the entity’s economic performance. As the level of disparity increases, the level of skepticism about a reporting entity’s lack of power is expected to increase.

**Excerpt from ASC 810-10-25-38G**

Consideration shall be given to situations in which a reporting entity’s economic interest in a VIE, including its obligation to absorb losses or its right to receive benefits, is disproportionately greater than its stated power to direct the activities of a VIE that most significantly impact the VIE’s economic performance. Although this factor is not intended to be determinative in identifying a primary beneficiary, the level of a reporting entity’s economic interest may be indicative of the amount of power that reporting entity holds.

The VIE model requires an ongoing reconsideration of whether a reporting entity is the primary beneficiary of a VIE due to changes in facts and circumstances.

In establishing this requirement, the FASB noted that requiring reconsideration in response to changes in facts and circumstances would provide benefits to users that would outweigh the anticipated costs to comply with the requirement. For example, if a party has a variable interest in a VIE in the form of a guarantee and over time the VIE’s performance declines significantly, then the guarantor may become the primary beneficiary. Further, the FASB also expects that the ongoing qualitative assessment would require less effort and be less costly than the quantitative assessment of expected losses and expected residual returns required under the earlier model.
When a reporting entity identifies a change in the primary beneficiary of a VIE, it will need to determine the date within the reporting period when the change occurred and recognize the effects as of that date.

Because of the requirement for ongoing assessment of a VIE’s primary beneficiary, the assessment of related parties (and de facto agents) must similarly be assessed on an ongoing basis.

**Will a VIE always have a primary beneficiary?**

Under certain scenarios none of the variable interest holders may be deemed to be the primary beneficiary and therefore no one would consolidate the entity. For example:

- The party that meets the power criterion does not hold a variable interest in the VIE, or does not meet the losses/benefits criterion.
- Power is 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.
- Power is not shared, but multiple unrelated parties perform the same activities that most significantly impact the entity’s economic performance and no party has power over the majority of these activities.

Examples illustrating the above scenarios will be discussed in further detail later in this chapter.

### 5.1.2 Power criterion

For a reporting entity to determine whether it has the power to direct the activities of the VIE that most significantly impact the VIE’s economic performance, it must (1) identify which activities most significantly impact the entity’s economic performance, and then (2) identify who has power over those activities.

**Identifying the power of an entity**

Determining which activities most significantly impact the entity’s economic performance may require significant judgment. In certain circumstances, an entity’s operations may be straightforward. Certain entities that are traditionally VIEs may have activities that are significantly limited and may not function in a manner that is similar to an operating business. In those instances, determination of which entity meets the power criterion may not require significant judgment. However, other more complicated structures involving multiple parties or highly structured securitizations, asset-backed financing arrangements or other typical SPE structures may require a significant level of judgment to determine which variable interest holder has the power to direct the activities of the VIE that most significantly impact the VIE’s economic performance.

The ability to exercise power over activities that most significantly impact the VIE’s economic performance must be considered even if a reporting entity does not exercise
Identifying the primary beneficiary of a VIE

its power. For example, the consideration of a reporting entity’s ability to act only when certain circumstances or events occur is likely to be more relevant in the case of entities that have no or limited day-to-day decision-making (e.g., the right to mitigate losses in the event of default of a financial asset); whereas, contingent power may be less relevant to the overall economic performance of an operating business.

A reporting entity’s assessment of power should consider the power to direct activities through its variable interest that may impact any of the entity’s variable interest holders, not just the equity holders. It is, therefore, possible that a variable interest holder may have power through a contract.

When determining which activities most significantly impact the economic performance of an entity, a reporting entity must focus on all of the risks that the entity was designed to create and pass through to its variable interest holders. In other words, the risks that the entity was designed to create and pass through to its variable interest holders should be based on the VIE model (rather than solely based on the economics that are created for the equity investors or residual holders).

Factors to consider in evaluating which decisions most significantly impact performance

Once the risks that the entity was designed to create and pass along to its variable interest holders have been identified, an analysis over the key decisions that could be exercised relating to those risks should be performed. A careful consideration of the following factors may prove helpful in deciding which activities most significantly impact economic performance:

- How each decision impacts the risks that the entity was designed to create.
- How the decisions impact the cash flows of the entity created for the benefit of variable interest holders.
- How the decisions impact margins of the entity.
- Whether the decisions could increase revenue of the entity.
- How the decisions could affect the overall fair value of the entity.
- The nature of the entity’s assets and how the decisions could impact the fair value of those assets.
- Expectations regarding the life of the entity and expectations regarding which decisions will be made over the life of the entity.

If the activities that impact the entity’s economic performance are directed by multiple unrelated parties and if the nature of the activities that each party is directing is not the same, then an entity will have to identify which party has the power to direct the activities that most significantly impact the entity’s economic performance. One party, if any, will have this power, and that party will be deemed to meet the power criterion. It is also possible that this conclusion can change over time—either by the
contract terms, through passage of time or upon specific events in which case the primary beneficiary can change.

**EXAMPLE 5-1**

Fruit Co. and Bottle Co., unrelated parties, form an entity Juice Co. Both Fruit Co. and Bottle Co. contribute an equal amount of cash and receive a 50 percent equity interest in Juice Co. Fruit Co. is an agricultural company specializing in the production of organic fruit used in high-end fruit drinks. Bottle Co. bottles and distributes beverages throughout the U.S. Fruit Co. and Bottle Co. formed Juice Co. for the purpose of manufacturing organic fruit juices for distribution to retailers throughout the U.S. Juice Co. has been determined to be a VIE. Apart from their equity interest, neither Fruit Co. nor Bottle Co. holds any other variable interest in Juice Co. How should Fruit Co. determine if it meets the power criterion?

First, Fruit Co. must determine the purpose and design of Juice Co., including the risks it was designed to create and pass through to its variable interest holders. Juice Co. was created to provide Fruit Co. access to Bottle Co.’s low cost bottling process as well as its distribution network while providing Bottle Co. access to Fruit Co.’s supply of organic fruit. Profits and losses of Juice Co. will be allocated equally to Fruit Co. and Bottle Co. based on their equity ownership percentages.

Next, Fruit Co. must determine which activities of Juice Co. most significantly impact its economic performance and determine whether it has the power to direct those activities. The party with the power to direct those activities would meet the power criterion.

Fruit Co. has determined the activities which most significantly impact Juice Co.’s economic performance are as follows:

<table>
<thead>
<tr>
<th>Activity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agricultural</td>
</tr>
<tr>
<td>Production/Bottling</td>
</tr>
<tr>
<td>Distribution</td>
</tr>
</tbody>
</table>

Next, Fruit Co. must determine which party has the power over the activities which most significantly impact the economic performance of Juice Co. Fruit Co. has determined the parties with the power to direct activities which most significantly impact Juice Co.’s economic performance as follows:

<table>
<thead>
<tr>
<th>Activity</th>
<th>Responsible party</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agricultural</td>
<td>Fruit Co.</td>
</tr>
<tr>
<td>Production/Bottling</td>
<td>Bottle Co.</td>
</tr>
<tr>
<td>Distribution</td>
<td>Bottle Co.</td>
</tr>
</tbody>
</table>
If each of the significant activities identified above carried the same importance in determining Juice Co.’s economic performance (which may be very difficult to demonstrate in practice), Bottle Co. would likely be deemed to meet the power criterion as it has the power to direct the majority of the activities (production/bottling and distribution) which most significantly impact the economic performance of Juice Co.

**EXAMPLE 5-2**

Assume the same facts as Example 5-1, except Fruit Co. has determined the agricultural activities (i.e., the growth of the core ingredient in Juice Co.’s primary product) have a more significant impact on the economic performance of Juice Co. than the production/bottling and distribution activities combined.

Following an analysis process similar to that in the previous example, Fruit Co. must determine which party has the power over the activities which most significantly impact the economic performance of Juice Co. In this example decisions made during the agricultural activities by Fruit Co. are the most significant activities impacting Juice Co.’s economic performance. Therefore, Fruit Co. would likely meet the power criterion as it has the power over the most significant activities of Juice Co. regardless of the number of activities directed by each reporting entity.

*Power exists in a fiduciary contract*

There can be circumstances where the power that most significantly impacts economic performance is held through a fiduciary service contract (e.g., a service contract that is not a variable interest under the entity). In this circumstance, there would be no primary beneficiary since the contract is not a variable interest. We believe it would be unusual for the power to be truly vested in a party or parties (including related parties) which have no participation in the variability of the entity in some form.

**EXAMPLE 5-3**

Reporting Entity A holds a small senior interest in a VIE and is a servicer to a VIE that is a securitization vehicle which holds mortgage loans. It is determined that Reporting Entity A through its contract as servicer has “power” to make decisions that most significantly impact economic performance of the VIE. Reporting Entity A has determined that its service contract is not a variable interest despite the additional senior interest it holds in the entity when assessing under ASC 810-10-55-37 (see VE 3.3.9).

In this fact pattern, since the power exists in a contract that is not a variable interest, Reporting Entity A is not deemed the primary beneficiary since its senior interest alone does not provide Reporting Entity A with power to make decisions that most significantly impact economic performance.
Impact of contingent decisions in identifying the power of the VIE

In identifying the decisions that most significantly impact the economic performance of a VIE, decisions that are contingent upon a future event should be considered in assessing the power criterion. In some situations, the power that most significantly impacts the economic performance of the VIE may not be able to be acted upon until a contingent event occurs. In fact, in some entities, all actions are predefined and self contained and there are no substantive decisions to be made unless certain specific contingent events occur.

ASC 810-10-55-96 through 55-109 includes an example which is useful in understanding this concept. The example is a commercial mortgage backed securitization in which the VIE funds the purchase of commercial mortgage loans by issuing fixed rate debt to third-party investors and equity to a third-party who also performs special servicing function. The transferor to the VIE performs primary servicing activities. Upon default of a mortgage loan, the administration of that loan is transferred to the special servicer. In this example, it is concluded that the power that most significantly impacts the economic performance of the VIE is the power to manage the defaulted assets. This power is held by the special servicer and the special servicer is deemed to hold the power under the power criterion, even though the power cannot be executed until a contingency (i.e., default or delinquency of an asset) occurs.

This analysis becomes more difficult when there are significant activities that are performed during the period before the contingent event occurs. For example, if it is determined that the activities performed before the contingent event occurs are significant to the economic performance of the entity, then there could be a different variable interest holder who meets the power criterion before and after the occurrence of the contingent event. In other words, a “change” in power occurs upon the occurrence of the contingent event. However, if it is determined that the events which occur prior to the contingent event are not significant to the entity’s economic performance, it may be determined that the activities which occur after the contingent event may drive the determination of power criterion even prior to the occurrence of the contingent event. In other words, the contingent event “triggers” the most significant activities of the entity.

If it is determined that the activities which occur both before and after the contingent event may significantly impact the economic performance of the entity, the power criterion analysis should focus on the purpose and design of the entity, the significance of the activities throughout the life of the entity, the ability of the variable interest holders to impact the occurrence of the contingent event and the likelihood of the contingent event occurring. The assumptions about which activities most significantly impact the economic performance of the entity may change as of each reassessment date. For example, if an entity appears to have significant activities that are linear (i.e., in stages) such that each significant activity is contingent upon the prior significant activity, the focus may be on the uncertainty of completing the initial stage and each subsequent stage as well as which stage will most significantly impacts the economic performance over the life of the entity based on assumptions at the date of the assessment.
EXAMPLE 5-4

An entity is formed by Company A and Company B for the purpose of constructing a manufacturing facility. Company A and Company B each own 50 percent of the equity ownership of the entity. The entity is determined to be a VIE. Once construction is complete, the VIE will operate the facility and sell the manufactured goods to third parties unrelated to Company A and Company B. Company A is responsible for directing the significant activities during the construction of the manufacturing facility, while Company B will direct the significant activities related to manufacturing and sales of the finished product after construction of the facility is complete. All the appropriate approvals for the manufacturing site have been obtained (e.g., permits) and Company A has constructed similar facilities in the past.

The decisions made during both the construction phase and the subsequent manufacturing and sales stage are determined to have a significant impact on the economic performance of the entity. Neither Company A nor Company B have any other variable interest in the VIE.

In this example, the variable interest holder that meets the power criterion during the construction stage and after may be different. The VIE was created with two separate and distinct phases, both of which will significantly impact the economic performance of the entity. Company A and Company B have entered into similar projects in the past with each party having the responsibility for similar activities. In each case, the construction phase was successfully completed in accordance with the business plan and approvals have been obtained to construct the facility and Company B was able to begin manufacturing and selling the finished product in accordance with the entity’s original business plan.

In this example, given Company A’s positive historical experience in completing similar projects and the expectation that construction will be successfully completed, Company B may be deemed to meet the power criterion throughout the lifecycle of the entity (even during the construction phase) since the activities over which it has power (manufacturing and sales) are truly the drivers of the entity’s economic performance.

If on the other hand, significant uncertainties existed (such as zoning and design issues) with respect to the construction and/or Company A did not have a positive historical experience in successfully completing similar projects, then Company A may be deemed to meet the power criterion during the construction phase and the power would shift to Company B at or near completion.

EXAMPLE 5-5

An entity is formed for the purpose of developing, manufacturing and distributing a pharmaceutical drug candidate. The entity is determined to be a VIE. The VIE obtains legal title to the drug candidate and the objective of the entity is to perform further research and development on the drug candidate with the goal of obtaining approval from the FDA for commercialization of the drug. Company A, a variable interest holder, is responsible for all decisions regarding the activities of the VIE throughout the FDA approval process. Company B, a variable interest holder, will be responsible for all significant activities post FDA approval, including manufacturing, marketing
and distribution of the drug. It is determined that the activities performed during both
the initial stage (FDA approval) and subsequent stage (manufacturing, marketing and
distribution) will have a significant impact on the economic performance of the VIE.

Both Company A and Company B have the power to direct significant activities of the
VIE which will impact its economic performance. However, Company B’s power is
contingent upon the successful development of the drug and receipt of required
approvals. The drug is currently in Phase I clinical trials and there is significant
uncertainty regarding the likelihood of the drug reaching FDA approval.

Since there are significant uncertainties which exist as of the assessment date, the
determination of power should be based on the significant activities that exist during
the initial stage. Therefore, it is likely that Company A would meet the power criterion
since it has the power to direct the activities that will have a significant impact on the
VIE’s economic performance during the initial stage.

However, once the uncertainty regarding the receipt of FDA approval has lapsed, the
determination of which variable interest holder meets the power criterion should
focus on which party has the power to direct the significant activities during the
remaining life of the entity (i.e., manufacturing, marketing and distribution) which is
likely to be Company B in this example. In other words, once the FDA approval
contingency has been met it is likely that the party determined to meet the power
criterion will change.

*Shift in who holds the power — Reconsideration events*

In some circumstances, the party that meets the power criterion may change over
time. For example the decisions that impact the economic performance of the entity
may be consistent throughout an entity’s life, but when certain contingencies are met,
power may shift from one party to another. One example of such a scenario is if an
event of default occurs and one of the parties in an entity can take over key decisions
of an entity. In contrast to the previously discussed examples, these scenarios involve
the same on-going significant activities throughout an entity’s life cycle, and the
contingent event determines which entity will have the power to direct those
significant activities. In these situations, we have referred to the impact of the
contingent event as a “shift” in power in the same power versus a “change” in power as
illustrated in the previous examples. Since the VIE model requires an ongoing
reconsideration of the primary beneficiary, events involving “shift” in power will
require special consideration.

In situations involving “shift” in power, determining which party meets the power
criterion will likely require significant judgment during the initial assessment of
power as well as during each subsequent reassessment. The basic model for
determining which entity meets the power criterion does not change in these
situations. However, if it is determined that the activities performed both before and
after the contingent event occurs are significant to the economic performance of the
entity, which will likely be the case in the context of a power shift, then the party who
meets the power criterion may change after the contingent event occurs.
Some examples of when power may shift from one party to another and thereby change the determination of the primary beneficiary include:

- The expiration of kick out rights or participating rights.
- The trigger of a contingent event that causes kick-out rights or participating rights to become exercisable.
- Acquisition of interests or contractual arrangements which allow a party to now exercise power over the entity.

**EXAMPLE 5-6**

Company A and Company B purchase output from Company X that owns and operates a power plant under a power purchase agreement (PPA). Company X is determined to be a VIE and both Company A and Company B’s PPAs are determined to be variable interests. The estimated life of the power plant is 30 years. Company A’s PPA provides it with the contractual right to operate the power plant for the first 15 years of the power plant’s life, while Company B’s PPA provides it with the contractual right to operate the power plant for the remaining 15 years. The power granted to Company A and Company B through their PPAs is determined to provide them with the power to direct the activities of Company X that will most significantly impact the economic performance of Company X during the effective periods of their contracts.

While both Company A and Company B’s variable interest provide them with the power to direct the significant activities of Company X. However, Company B’s power is contingent upon the passage of time and does not become effective until Company A’s power ceases. In these situations it may likely be determined that Company A meets the power criterion during its contractual period, while Company B will meet the power criterion once Company A’s contract has expired and Company A no longer has a variable interest in Company X.

**EXAMPLE 5-7**

A VIE is created for the purpose of purchasing fixed-rate residential mortgage loans from a Transferor. The entity finances the purchase of the mortgage loans by issuing three tranches of securities, a senior tranche that is guaranteed by a financial guarantor (FG Company), a subordinate tranche and a residual interest. The Transferor retains servicing responsibilities over the mortgage loans. Upon a predefined event of default (which is triggered based upon a significant amount of delinquencies of the underlying assets), Transferor is automatically removed as the servicer of the entity and FG Company assumes the role of servicer.

As servicer, the Transferor is responsible for servicing the non-performing loans, which includes contacting defaulting borrowers, determining if and when a borrower should be granted a loan modification, as well as determining when to foreclose on the collateral underlying a delinquent mortgage loan. Servicing of non-performing loans is determined to have the most significant impact upon the economic performance of the entity. Therefore, the Transferor in its role as servicer meets the power criterion. However, if an event of default occurred and FG Company takes over servicing
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Responsibilities (which conveys power), FG Company would be the entity’s primary beneficiary since power shifted. FG Company would also meet the losses/benefit criterion as it would potentially be exposed to significant losses.

Evaluation of call options in assessing the power criterion

Call options (i.e., the right to purchase the interests of an entity) often exist in VIEs. For example, one of the two parties to a joint venture may often provide the other party the right to purchase its interest in the entity for a fixed price or at a fixed formulaic price. The VIE model does not specifically address how physically or net share settled call options that give the holder of the call option power over the entity if exercised should be considered. Some have considered that in the case of a call option, the holder has the ability to seize power from other parties with respect to the entity. As a result, some believe that a call option should be viewed similar to a kick-out right as described further in this section (VE 5.1.2). We believe that while there are similarities to kick-out rights since the holder of a kick-out right has the ability to seize power from another party making decisions, the holder of a call option generally is required to make a significant cash outlay (or economic value in cases in which there is a cashless exercise feature). Therefore, call options are not economically the same as kick-out rights.

In many cases, the existence of the call option will not impact the analysis of power however, we do believe that call options should be carefully considered to determine if the substance of the call option gives the holder the power to make decisions that most significantly impact the economic performance of the VIE. If the call is currently exercisable, we believe that the following factors should be considered in making this evaluation:

- **The strike price and other key terms of the call option.** If the call option has an exercise price at fair value instead of an exercise price based on a fixed price or formula, it would be highly unlikely that the call option in and of itself would provide the holder with power. However, if the option’s exercise price is based a fixed amount or on a formula, the intrinsic value of the option should be considered. In situations in which the option is deep-in-the-money, it may be likely that the substance of the arrangement is that the holder of the option has power over the entity.

- **The significance and importance of the holder of the option’s potential ownership in the entity.** If the VIE’s activities are of the utmost importance to the holder’s ongoing business, there is a greater potential for the holder to effectively influence the entity. However, in most cases, the level of influence will not be so great as to allow the holder to have the ability to make decisions that most significantly impact the economic performance of the VIE.

- **The overall level of control held by the holder of the option.** Based on the existence of the call option by itself or with other variable interests held by the holder (including its related parties/de facto agents), the holder may have the ability to make decisions that most significantly impact the economic performance of the VIE.
The overall importance of the holder’s operations to the ongoing business activities of the VIE. The VIE’s dependence on the holder to conduct its business activities may effectively provide the holder with power over the VIE.

The existence of barriers to exercise the option. A careful consideration of factors that could prevent or limit the ability of the holder to exercise the call option (e.g., due to illiquidity, regulatory concerns or other factors) may lead to a conclusion that the holder does not have the power over the VIE through its call option.

The existence of conditions such that it would not be prudent, feasible and substantially within the control of the holder of the call to exercise the call option. For example, the counterparty to the call option controls technology that is critical to the VIE or the counterparty to the call option is the principal source of funding for the VIE.

If the call option can only be exercised when a substantive contingency occurs, we do not believe that such call options should be considered in the power criterion evaluation until the contingency is resolved (i.e., at the point in time that the call is exercisable). Additionally, if the call option is not currently exercisable merely due to the passage of time (e.g., call option that is exercisable after 5 years), then it is not considered in the power criterion evaluation until it is exercisable. Both these scenarios would be situations in which it is important to perform an ongoing analysis.

In all of the scenarios described above, it is assumed that the call option gives the holder the right to obtain power upon exercise. There can be some limited situations in which the holder of the call option may have voting rights or other decision making rights that legally exist in the call option itself (e.g., upon executing the call option, the holder may be granted the ability to elect board of directors of the VIE). In those cases, the rights granted should be considered in the evaluation of the power criterion.

Additionally, cash settled call options should not impact the power criterion analysis since these options do not give the holder any rights to make decisions that significantly impact the economic performance of the VIE.

Shared power

In certain situations the VIE model allows a reporting entity to determine that power is shared with other unrelated parties such that no one party meets the power criterion. In a shared power situation, no party, including the reporting entity, is deemed to be the primary beneficiary.
Excerpt from ASC 810-10-25-38D

If a reporting entity determines that power is, in fact, shared among multiple unrelated parties such that no party has the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance, then no party is the primary beneficiary. Power is shared if two or more unrelated parties together have the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance and if decisions about those activities require the consent of each of the parties sharing power...

Power is considered to be 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. In addition, each of the parties is required to consent to the decisions relating to those activities. The requirement to consent must be substantive. This principle is illustrated in the examples included in ASC 810-10-55-182 through 55-198. In this example, two unrelated companies are each responsible for manufacturing, distributing, and selling a product and are required to obtain each other’s consent with respect to the decisions relating to those activities. We believe that if there are more than two unrelated parties that participate in making decisions that have a significant impact on the economic performance of the entity by simple majority vote, power is still considered to be shared.

When a joint venture qualifies as a VIE, provided that each of the joint venture’s partners consent to the activities that most significantly impact the VIE’s economic performance, neither party would be required to consolidate the VIE unless the partners are considered related parties or de facto agents (see VE 5.1.4).

In determining if power is shared, a reporting entity must not only focus on whether a requirement to consent is present, but also needs to identify at what level within the entity the significant decisions reside. For example, if an entity establishes a board of directors consisting of representatives unilaterally approved by each equity holder (all unrelated parties), and the board of directors holds the power to direct the significant activities of the entity, power must be analyzed at the board level. In some cases, however, while the decisions of the board of directors may be shared, there may be significant decisions made by one of the venture partners through other contractual arrangements such as service or management contracts. The decisions made through those contracts should be considered in the analysis. A careful consideration of the decision making below the board should be performed when assessing the power criterion.

Additionally, a reporting entity should careful consider what happens when a “deadlock” occurs. For example, in many circumstances, two parties may be required to consent to an activity of an entity. Contractual clauses may exist to clarify what happens in the event that the parties do not agree to the decision at hand. If one of the parties has the ability to break the deadlock by voting a tie-breaking vote, it may be deemed to have the power over the entity and power would not be considered shared.

In other situations, the decisions that most significantly impact economic performance of the VIE may be required to be approved by a majority of the parties...
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involved in the entity rather than by unanimous consent. It is our understanding that the FASB’s focus on the words “consent” was not to necessarily require unanimous consent in order to determine whether power is shared. Rather the FASB’s intent was to clarify that shared power would not exist if there were key decisions of an entity and there were separate parties that could make such decisions unilaterally without requiring consent of the other parties (either majority or unanimous).

**EXAMPLE 5-8**

ABC Co., DEF Co. and XYZ Co., all unrelated parties, each hold a variable interest in Oak Co., a manufacturer of oak furniture for wholesale distribution to retail furniture stores. ABC Co., DEF Co. and XYZ Co. each obtained 33.33 percent of the equity of Oak Co. through equal contributions of cash upon formation of the entity. All profits and losses of Oak Co. are allocated to the equity investors pro-rata to their equity ownership. Apart from the equity interest, neither party holds any other variable interests in Oak Co.

The board of directors is comprised of the six directors—two each appointed by ABC Co., DEF Co. and XYZ Co. respectively. All decisions related to Oak Co.’s significant activities require approval by a two-thirds majority vote of the board of directors (i.e., four of the six directors).

Oak Co. has determined the activities which most significantly impact Oak Co.’s economic performance are:

1. purchasing raw materials,
2. manufacturing, and
3. sales.

In this scenario, it may likely be determined that ABC Co., DEF Co. and XYZ Co. have shared power of Oak Co. through their representation on the board of directors. Since all decisions regarding the significant activities of Oak Co. require approval by ABC Co., DEF Co. and XYZ Co. through their appointed directors, neither ABC Co., nor DEF Co. nor XYZ Co. can independently make decisions regarding the Oak Co.’s significant activities. Therefore, neither party is deemed to meet the power criterion since power is shared.

**EXAMPLE 5-9**

Assume the same facts as Example 5-8, except for the following:

ABC Co. holds 50 percent, while DEF Co. and XYZ Co. each hold 25 percent of the outstanding equity of Oak Co. Each party holds two Board of Director seats and a two-thirds vote is required to make the decisions that most significantly impact the economic performance of the entity.

In this scenario, the assessment of power would not differ from the conclusion in Example 5-8. The VIE model requires the determination of which party has the power
to direct the activities that most significantly impact the VIE’s economic performance. Even though the equity interests held by ABC Co., DEF Co. and XYZ Co. are not equal, all decisions regarding the significant activities of Oak Co. are directed by the board of directors which effectively require approval by ABC Co., DEF Co. and XYZ Co. through their appointed directors. Therefore, no single party can independently make decisions regarding the significant activities, and none of the parties would meet the power criterion.

However, the VIE model does call for increased skepticism in situations where an entity’s economic interest in a VIE, is disproportionately greater than its stated power to direct the significant activities of the VIE. While disproportionality itself may not be determinative, additional consideration should be given in those situations as the level of a reporting entity’s interest may be indicative of the amount of power that a reporting entity holds.

**Power over same activities but not shared**

If a conclusion is reached that power is not shared, but the same activities that most significantly impact the VIE’s economic performance are performed by multiple unrelated parties, then the party with the power over the majority of those activities will be considered to have met the power criterion. However, if no party has power over the majority of the activities, then no party will be deemed to meet the power criterion.

**Excerpt from ASC 810-10-25-38D:**

...If a reporting entity concludes that power is not shared but the activities that most significantly impact the VIE’s economic performance are directed by multiple unrelated parties and the nature of the activities that each party is directing is the same, then the party, if any, with the power over the majority of those activities shall be considered to have the characteristics in paragraph 810-10-25-38A(a).

This principle is illustrated in the example included in ASC 810-10-55-194 through 55-196 where two unrelated companies are each responsible for manufacturing, distributing, and selling a product in different locations and are not required to obtain each other’s consent to decisions relating to those activities. If neither company performs a majority of these activities, then the VIE does not have a primary beneficiary.

Another example of when this principle may be applied is in securitization vehicles wherein there may be three separate parties servicing separate and distinct pools of the underlying assets of an entity. Consider a situation in which Company A, B and C each perform servicing of the mortgage loans in a mortgage loan securitization. Additionally, each company can make servicing decisions independently (i.e., without the consent of any other party). Servicing of the financial assets is determined to be the power that most significantly impacts the economic performance of the entity. If neither Company A, B or C perform servicing for a majority of the assets of the vehicle, then it may be concluded that no party has the power of the entity.
In practice, we believe that this principle will not be applied frequently since very few entities have multiple parties performing the same activities without requiring consent of others.

The VIE model does not specify how “majority” should be determined in making this assessment. In other words, how should one measure whether a reporting entity holds power over a majority of decisions that are significant to the economic performance of the entity. In some circumstances, it may make sense to base such judgment on the effect each decision may have on the ongoing cash flows of the entity. For example, when two unrelated companies are each responsible for manufacturing, distributing, and selling a product in different locations and are not required to obtain each other’s consent to decisions relating to those activities, one may evaluate majority based upon the expectation of sales or profits to the entity. We believe that judgment should be applied in those circumstances, and conclusions should be consistent with the principles of identifying whether a party has the most significant decisions that could impact economic performance of the VIE.

**Impact of implicit or explicit financial responsibility in assessing the power criterion**

The VIE model requires that implicit and explicit financial responsibilities be considered in the primary beneficiary analysis. The VIE model provides an example of a sponsor that has an implicit or explicit financial responsibility to ensure that an entity operates as designed thereby giving the sponsor an incentive to establish arrangements that give it power to direct the activities that most significantly impact the economic performance of the entity.

**Excerpt from ASC 810-10-25-38F**

Although a reporting entity may be significantly involved with the design of a VIE, that involvement does not, in isolation, establish that reporting entity as the entity with the power to direct the activities that most significantly impact the economic performance of the VIE. However, that involvement may indicate that the reporting entity had the opportunity and the incentive to establish arrangements that result in the reporting entity being the variable interest holder with that power. For example, if a sponsor has an explicit or implicit financial responsibility to ensure that the VIE operates as designed, the sponsor may have established arrangements that result in the sponsor being the entity with the power to direct the activities that most significantly impact the economic performance of the VIE.

Determining whether a reporting entity has an implicit financial responsibility to ensure that an entity operates as designed will require judgment. We believe that the determination of what constitutes an implicit financial responsibility should consider all potential events—irrespective of how unlikely they are to occur.

In VIEs where there are no ongoing activities that have a significant impact on the VIE’s economic performance, the activities involved in setting up the entity (e.g., the selection of the assets for purchase by the entity, what occurs when the entity is dissolved, the rights of the various parties, etc.) are likely to be more important to this analysis. While such involvement in the design of an entity does not establish a
reporting entity as its primary beneficiary, it could provide the reporting entity with the incentive and ability to be the primary beneficiary.

**Impact of kick-out rights or participating rights in assessing the power criterion**

A reporting entity’s determination of whether it meets the power criterion shall not be affected by the existence of kick-out rights or participating rights unless a single reporting entity, including its related parties or de facto agents, has the unilateral ability to exercise those rights. Kick-out rights are defined for the purposes of this amendment as the ability of a reporting entity to remove, without cause, another reporting entity which holds the power to direct the activities of a VIE that most significantly impact the entity’s economic performance (see VE 4.2.2.4 for discussion with respect to liquidation rights). The FASB believes that many entities within the scope of the VIE model are highly structured and although substantive kick-out rights or participating rights might exist, they are not typically exercised and therefore should not be considered until exercised.

**Excerpt from ASC 810-10**

25-38C: A reporting entity’s determination of whether it has power to direct the activities of a VIE that most significantly impact the VIE’s economic performance shall not be affected by the existence of kick-out rights or participating rights unless a single reporting entity (including its related parties and de facto agents) has the unilateral ability to exercise those kick-out rights or participating rights. A single reporting entity (including its related parties and de facto agents) that has the unilateral ability to exercise kick-out rights or participating rights may be the party with the power to direct the activities of a variable interest entity that most significantly impact the entity’s economic performance.

20: ...Protective rights: Rights are designed to protect the interests of the party holding those rights without giving that party a controlling financial interest in the entity to which they relate. For example, they include any of the following:

a. Approval or veto rights granted to other parties that do not affect the activities that most significantly impact the entity’s economic performance. Protective rights often apply to fundamental changes in the activities of an entity or apply only in exceptional circumstances. Examples include both of the following:

1. A lender might have rights that protect the lender from the risk that the entity will change its activities to the detriment of the lender, such as selling important assets or undertaking activities that change the credit risk of the entity.

2. Other interests might have the right to approve a capital expenditure greater than a particular amount or the right to approve the issuance of equity or debt instruments.

b. The ability to remove the reporting entity that has a controlling financial interest in the entity in circumstances such as bankruptcy or on breach of contract by that reporting entity.
c. Limitations on the operating activities of an entity. For example, a franchisee agreement for which the entity is the franchise might restrict certain activities of the entity but may not give the franchisor a controlling financial interest in the franchisee. Such rights may only protect the brand of the franchisor.

**Excerpt from ASC 810-10-20**

Kick-Out Rights: The ability to remove the reporting entity with the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance.

Participating rights: The ability to block the actions through which a reporting entity exercises the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance.

Excluding the consideration of substantive kick-out rights is inconsistent with the voting interest model as described in ASC 810-20-25-8. As a result, the evaluation of kick-out rights under the VIE model and the voting interest model may lead to different consolidation conclusions. For example, consider a general partnership where the general partner has the power to direct matters that significantly impact the activities of the partnership, while the limited partners have substantive removal (kick-out) rights. Under the VIE model, if the entity under consideration is a VIE, the general partner would likely be deemed to meet the power criterion because substantive kick-out rights are not held by one party and are effectively ignored under the model. In contrast, if the entity is not a VIE and must be evaluated under the voting interest model, the general partner would be precluded from consolidating the partnership due to the existence of those substantive kick-out rights.

**Evaluating whether a kick-out right is substantive**

We believe that kick-out rights should only be considered under the guidance when the kick out right is substantive. In making the evaluation of whether or not a kick out right is substantive, we believe that a determination should be made as to whether there are any barriers to exercise such rights. A careful consideration of the following types of potential barriers to exercise should be made to ensure that there are no barriers to exercise the kick out rights (note this is not meant to be an all inclusive list).

- **Contractual** — Conditions that make it unlikely that a kick-out right can be exercised (e.g., conditions that narrowly limit the timeframe in which the right may be exercised).

- **Commercial** — Financial penalties or operational barriers that act as significant disincentives for replacing the party.

- **Commercial** — An inadequate number of qualified replacements for the party are available or compensation is inadequate to pay a qualified replacement.
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- Procedural or informational — The absence in the applicable agreements (or in the applicable laws or regulations) of an explicit, reasonable mechanism that allows the holder to exercise those rights or to obtain the information necessary to exercise them.

**Consideration of participating rights**

The guidance clarifies that protective rights should not be considered in assessing whether a reporting entity has the power to direct activities that most significantly impact a VIE’s economic performance. Consistent with kick-out rights, only substantive participating rights that can be unilaterally exercised by a single reporting entity (including related parties and de facto agents) should be considered in determining which reporting entity, if any, meets the power criterion. Participating rights are defined as the ability to block the actions through which a reporting entity exercises the power to direct the activities of a VIE that most significantly impact the entity’s economic performance.

Excluding the consideration of participating rights is inconsistent with the approach taken for voting-interest entities under ASC 810-20-25-11 through 18. Consequently, the evaluation of participating rights under the guidance and under the voting-interest model may lead to different consolidation results.

See VE 2.3 for the deferral of the VIE model as amended by ASU 2009-17, for certain investment entities that have the attributes of entities subject to ASC 946 (the “investment company guide”).

### 5.1.3 Losses/benefits criterion

If a reporting entity has met the power criterion, it will then need to determine whether it has the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity or the right to receive benefits from the entity that could potentially be significant to the variable interest entity. Both the power criterion and the losses/benefits criterion are required for the reporting entity to be the primary beneficiary of the VIE.

**Qualitative analysis**

Under the VIE model, determining whether a reporting entity has the obligation to absorb losses of or the right to receive benefits from the VIE that could be potentially significant to the VIE is not based on a quantitative expected loss/expected residual return calculation required under the previous model. Rather, this assessment is intended to be a qualitative judgment-based analysis which considers all of the facts and circumstances about the terms and characteristics of the variable interest(s), the design and characteristics of the VIE and the other involvement that the reporting entity may have with the VIE.

VE 3 outlines the concept of a variable interest and determination of whether the reporting entity has a variable interest or potentially multiple variable interests in the entity. The qualitative analysis performed to determine if the reporting entity has the obligation to absorb losses or receive benefits that could potentially be significant to
the VIE considers all variable interests identified in that analysis. However, this analysis would not include other involvement of the reporting entity with the VIE that are not considered to be variable interests.

The losses/benefits criterion only requires that either the benefits received or losses absorbed through a reporting entity’s variable interest (not both) have the potential to be significant. This is a different concept from the previous guidance since it is not focused on variability from an expected result. For example, consider a variable interest holder which holds a 100 percent equity interest in a VIE, but the equity interest is small in comparison to the entity’s overall capitalization. While the investor may only be exposed to losses up to the amount invested, the investor has the ability to receive benefits that could potentially be significant to the VIE. In another circumstance, if a variable interest holder holds the majority of the capital of the VIE, but is a senior interest holder and the VIE is non-performing, then such variable interest holder may incur a larger loss compared to the subordinate investors or could potentially be required to provide additional funding. In this case, even though the interests held by the variable interest holder are senior to the interests held by other variable interest holders, such senior interests and obligations could be potentially significant to the VIE.

Although multiple entities could have obligations or rights that could potentially be significant, only one reporting entity is expected to meet the power criterion.

**Probability**

All scenarios, irrespective of probability, should be considered in assessing whether the right to receive benefits or the obligations to absorb losses could be potentially significant to the VIE. The losses/benefits criterion also requires the reporting entity to consider that although it may not have rights or obligations that are currently significant, its variable interest may provide it with obligations or rights that may be significant to the VIE in the future even under seemingly improbable scenarios. The FASB concluded that these considerations were critical because obligations or rights that could potentially be significant often identify the reporting entity that explicitly or implicitly has the power to direct the activities that most significantly impact the economic performance of the VIE.

**Significance**

During the standard setting process, the FASB received requests for additional guidance on the losses/benefit criterion, specifically in interpreting “potentially significant to the VIE.” The FASB decided not to provide additional guidance based on the rationale that any such guidance would provide “bright lines” that would be used in practice as the sole factor when determining whether such obligations or rights could potentially be significant to the VIE. The determination of whether the losses/benefits of a VIE which are absorbed/received by a reporting entity could potentially be significant to the VIE can vary and should be based on the individual facts and circumstances presented. The VIE model contains examples that illustrate the principles to be considered when determining the party that is the primary beneficiary. These examples do not include explicit information on how a reporting entity concludes whether or not it has the obligation to absorb losses or the right to
receive benefits that could potentially be significant to the VIE, but rather confirm that all variable interests should be analyzed in determining if a reporting entity meets the losses/benefits criterion.

Consistent with the FASB's determination, we expect that each analysis will be based on individual facts and circumstances and will require judgment to be applied. There are certain relationships that we expect will result in a reporting entity concluding that it has the obligation to absorb losses or right to receive benefits that could potentially be significant to the VIE. For example, if an entity has a decision maker or service provider contract which is considered a variable interest based on the criteria listed in the VIE model (refer to VE 3.3.9 for further details), particularly if the decision maker or servicer would 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, it is likely that the reporting entity has the obligation to absorb losses or right to receive benefits that could potentially be significant to the VIE.

We believe that the following factors may assist in the determination of whether potential losses or benefits could be potentially significant to the VIE:

- Overall design of the VIE including the terms of the interests and capitalization structure. For example, the primary risks or sources of variability of the VIE.

- Whether the reporting entity's exposure to the entity losses or its benefits from the entity's gains are economically "capped." For example, in situations whereby the reporting entity's rights to upside benefit is unlimited (e.g., through an equity or residual interest in the entity) it is more likely to provide benefits compared to a senior interest that is provided a fixed return and has no rights to earnings of the entity above that fixed return.

- Subordination of the variable interest. Variable interests that are more subordinate in the entity would be expected to be exposed to potentially more significant benefits and losses of the entity. In other words, the level of interest held as a percentage of the class of interests that could potentially be significant to the VIE decreases based on the interest's standing in the waterfall.

- The percentage of the class of interest held by the reporting entity.

- Understanding the reasons as to why the interest is held by the reporting entity. For example, if the reason is important to the overall design of the entity from a marketing or other perspective, it may indicate that the reporting entity has potentially significant benefits and losses.

Additionally, at the 2009 AICPA SEC Conference, Arie Wilgenburg of the SEC staff stated:

*So what is a significant financial interest? Well, Statement 167 describes such an interest as one that either obligates the reporting enterprise to absorb losses of the entity or provides a right to receive benefits from the entity that could potentially be significant. That description leaves us with an important judgment to make regarding what could potentially be significant. In the past few weeks, the staff has*
been thinking about this concept. While there is no “bright-line” set of criteria for making this assessment, I thought it would be helpful to provide some thoughts in this area. First, similar to how we have talked in the recent past about materiality assessments being based on the total mix of information, we believe that assessing significance should also be based on both quantitative and qualitative factors. While not all-inclusive, some of the qualitative factors that you might consider when determining whether a reporting enterprise has a controlling financial interest include:

- **The purpose and design of the entity.** What risks was the entity designed to create and pass on to its variable interest holders?

- **A second factor may be the terms and characteristics of your financial interest.** While the probability of certain events occurring would generally not factor into an analysis of whether a financial interest could potentially be significant, the terms and characteristics of the financial interest (including the level of seniority of the interest), would be a factor to consider.

- **A third factor might be the enterprise’s business purpose for holding the financial interest.** For example, a trading-desk employee might purchase a financial interest in a structure solely for short-term trading purposes well after the date on which the enterprise first became involved with the structure. In this instance, the decision making associated with managing the structure is independent of the short-term investment decision. This seems different from an example in which a sponsor transfers financial assets into a structure, sells off various tranches, but retains a residual interest in the structure.

As previously mentioned this list of qualitative factors is neither all-inclusive nor determinative and the analysis for a particular set of facts and circumstances still requires reasonable judgment.

### 5.1.4 Identifying the primary beneficiary within a related party group — Related party tie breaker

**Excerpt from ASC 810-10-25-44**

In situations in which a reporting entity concludes that neither it nor one of its related parties has the characteristics in paragraphs 810-10-25-38A but, as a group, the reporting entity and its related parties (including the de facto agents described in the preceding paragraph) 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:

- **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.

When to apply the related party tie-breaker

Related parties and de facto agency relationships can play a critical role in (i) the determination of whether the entity is a VIE, and (ii) the determination of the VIE’s primary beneficiary, if one exists.

The VIE model requires that the individual parties within a related party group (including de facto agents) are required to first separately consider whether there is a single party in the related party group (including de facto agents) that meets both the power and losses or benefits criteria on their own as though no related party relationship existed. If one party within the related party group meets both these criteria, such reporting entity is the primary beneficiary of the VIE and no further analysis is needed. This is a significant change to the model that was introduced by the previous VIE model. Under the prior guidance, all related party relationships were aggregated as one and if the related party interests as a group were exposed to a majority of the entity’s expected losses and/or expected residual returns, the related party tie-breaker was needed to be assessed. This change to the model is expected to reduce the frequency with which the related party tie-breaker is employed.

Generally, we believe the related party tie-breaker would apply when the related party group, rather than a single party in the group, meets the power and losses/benefits criteria (i.e., group would be the primary beneficiary) in the following situations:

- Power is shared among the related party group.
- One of the parties in the related party group meets the power criterion on a standalone basis but not the losses/benefits criterion. However, the related party group collectively meets the losses/benefits criterion.
- The same activities that most significantly impact the entity’s economic performance are performed by multiple related parties but no party has power over a majority of the activities (but the related party group collectively has power over the majority of the activities).

If no party within the related party group on its own meets both the power and losses/benefits criteria, but the related party group does as a whole meets these two criteria, the determination of primary beneficiary within the related party group is based upon an analysis of the facts and circumstances with the objective of determining which party is most closely associated with the VIE (i.e., the related party tie-breaker must be performed).
Applying the tie-breaker

Determining the primary beneficiary under the tie-breaker requires significant judgment. While the principle supporting the guidance is fundamental, identifying the party most closely associated with the VIE, its application requires care. Factors to consider in making the assessment include:

- the four key indicators described in the VIE model, and
- the relative weighting of these indicators based on the individual facts and circumstances of each transaction and structure.

The four key factors are explained in more detail below.

Principal/agency relationship

The first indicator for identifying the primary beneficiary from the related-party group is the existence of an agency relationship among the parties. If one member of the group was acting in the capacity of an agent of another member of the related party group, this would be a strong indicator that the principal would be the primary beneficiary. This type of relationship can take many forms, including de facto agency relationships defined in the VIE model. Additionally, there may be situations beyond those included in the VIE model in which an agency relationship may exist among members of the related-party group.

When evaluating whether or not an agency relationship exists among members of the related-party group, it may be helpful to analogize to other accounting guidance relating to principal-agency relationships. ASC 470-50, Debt—Modifications and Extinguishments, describes the appropriate accounting for modification of debt instruments and lists several indicators that may be useful in determining when a third-party intermediary is acting as an agent on behalf of a debtor. ASC 605-45, Revenue Recognition—Principal Agent Considerations (ASC 605-45), describes the appropriate revenue recognition in transactions depending on whether the reporting entity is acting as an agent or a principal. The existence of any indicators listed under Gross Revenue Reporting in ASC 605-45 may indicate that the reporting entity is acting as a principal. The existence of any indicators listed under Net Revenue Reporting in ASC 605-45 may indicate that the reporting entity is acting as an agent.

There may be situations in which two reporting entities are related parties under the de facto agency provisions of the VIE model, but the identification of which party is acting as the agent and which party is acting as the principal may not be clear. For example, two reporting entities may share a common director. In situations such as these, even though the reporting entities are related parties for purposes of applying the VIE model, however, they may not be acting as agents of one another. Accordingly, the reporting entity should place more weight on the other indicators.

Relationship and significance of activities

The second indicator for identifying the primary beneficiary in the related-party group considers the relationship of the VIE to each of the members of the related-party
Identifying the primary beneficiary of a VIE group, as well as the significance of the VIE’s activities to those members. The member of the group that this indicator points toward will depend upon the point of view of the reporting entity carrying out the evaluation. For example, two members of a related party group may come to the opposite conclusion when evaluating this indicator, as they may each have an inherent bias when evaluating their relationship with the VIE.

The evaluation of the significance of the VIE’s activities should be based on all the relationships between the VIE and the various members of the related-party group. This analysis should not merely focus on the size of the VIE in relation to the size of the members of the related-party group. It should not be presumed that the activities of the VIE are more significant to a smaller party than a larger one, merely because one entity is smaller than the other. Rather, many factors should be considered, such as:

- whether one party is significantly dependent upon the VIE as a supply/distribution source;
- whether one party is the lessee of the sole asset of the entity;
- whether the reporting entity funds research and development of the VIE that is integral to a party’s underlying operations;
- the nature of the VIE’s business activities and whether they are inherently aligned with a related party;
- the significance of VIE sales of product (or output) to a related party;
- understanding the nature of service contracts, management contracts, or other contracts entered into by the VIE with a related party and their importance to the underlying business activities of the VIE;
- whether any related party has a call option to acquire significant or major assets from the VIE or another related party’s variable interest; and
- whether any related party has an option to put its variable interest to another related party.

When evaluating this indicator, a reporting entity may also look to the indicators provided in VE 2.

**Variability associated with anticipated economics**

The third indicator for identifying the primary beneficiary from the related-party group focuses on the economics of the arrangement. When analyzing this indicator, consideration should be given to the member of the related party group, relative to the others, that has the potential to receive additional benefits or absorb additional losses of the VIE based on changes in the entity’s anticipated economic performance. Note that this analysis takes into account the member’s obligations and rights throughout the lifecycle of the VIE and considers the extent to which the member’s expected
rights to receive benefits and obligation to absorb losses change based on variation of the anticipated economic results of the VIE.

There may be situations in which one member of the group is exposed to such a large portion of the variability associated with the VIE’s anticipated economic performance that it would be difficult not to conclude that the party is the primary beneficiary. However, all qualitative factors, including principal/agency relationship and the design of the entity should be considered. If the reporting entity that is exposed to the variability of the VIE’s anticipated economic performance is merely acting as an agent of another reporting entity, the reporting entities must use reasoned judgment in order to understand why such an arrangement exists and to identify the appropriate primary beneficiary.

In determining how much weight to place on this indicator, we believe that the nature of the related-party relationship should be considered. If, for example, the related party relationship is that of a parent company and its wholly-owned subsidiary, the contractual allocation of incremental benefits and losses generated because of variability from the VIE’s expected results is of little importance to the parties, and therefore little weight should be placed on this indicator. However, if the relationship is that of two independent companies investing in a joint venture where one of the companies cannot sell or transfer its interest without the other’s prior approval, more significant weight may be placed on this indicator. Varying degrees of weighting should be applied between those two extremes.

*Design of the VIE*

The fourth indicator for identifying the primary beneficiary from the related-party group focuses on the design of the VIE. When evaluating this indicator, reporting entities should focus on the structure of the VIE in an attempt to identify the appropriate primary beneficiary. There may be instances where it is clear that an entity was designed or structured for the benefit of one member of the related-party group. Examples of these types of relationships may include:

- An entity established for the securitization of certain assets and the transferor of those assets;
- An entity established to own and lease a single-asset to the lessee of that asset; and
- An entity established to provide off-balance sheet financing and the beneficiary of that financing.

Again, this indicator will be subject to the judgment of those evaluating the VIE and the related-party group, and certain structures/transactions will be more obvious than others.
5.2 Questions and interpretative responses

Question 5-1
If a party within a related party group is the primary beneficiary on a standalone basis, but another party within that group receives the majority of the economics, should the related party tiebreaker be applied?

PwC response
No. If one party in the related party group meets both of the power and benefits/losses criteria, then that party is the primary beneficiary. In this fact pattern, the power criterion should be carefully analyzed to ensure any implied power due to one party receiving the majority of the economics was appropriately considered in the determination of the primary beneficiary. To the extent the power criterion is not clear and a reporting entity could potentially conclude upon shared power between two parties within the related party group, the related party tiebreaker should be performed. This analysis will require significant judgment based upon individual facts and circumstances.

Question 5-2
Can a board of directors be viewed as “one party” when considering whether one party has the unilateral ability to exercise substantive kick out rights?

PwC response
In virtually all cases, a board of directors will not be considered as “one party” for determining if one party has the unilateral ability to exercise a substantive kick-right under the VIE model. Generally, a board of directors consists of directors who are elected by the shareholders of the entity as a group. In essence, the board of directors is acting in a fiduciary capacity on behalf of the shareholders of the entity and should not be viewed as being one party in determination of whether a reporting entity meets the power criterion, or in the assessment of whether an entity is a VIE (refer to VE 4). This view has been discussed with both the FASB and SEC staff who agreed with this conclusion. If, however, the board of directors is controlled by one controlling shareholder of the entity, it may be acceptable to view the kick-out rights as being held by one party if they are substantive. However, the facts and circumstances will need to be carefully considered in those limited scenarios.
Question 5-3

Company A (reporting entity) enters into a purchase and sale agreement with Company X (entity) under which Company A will buy from Company X and Company X will sell to Company A land and building. Company X’s sole asset is the land and building under the agreement. As part of the agreement, Company A is required to pay a non-refundable deposit to Company X. Company A also has the right to terminate the contract, subject to the loss of its deposit. Assuming that Company A has a variable interest in Company X due to the purchase and sale agreement (see Example 3-6 for details), and that Company X is a VIE (see Question 4-10 for details), will Company A be considered to be the PB of Company X due to its non-refundable deposit to Company X?

**PwC response**

Maybe, depending on an assessment as to whether Company A has a controlling financial interest in Company X through an evaluation of both the power and losses/benefits criteria in ASC 810-10-25-38. For example, in land purchase option agreements, the buyer may have the rights to decide on amenity and zoning density issues, or for rental property agreements, the buyer may have rights to control leasing decisions. To the extent the purchase and sale agreement transfers the rights to the activities that most significantly impact the economic performance of the VIE to the buyer, where the buyer also has a substantive non-refundable deposit, it is likely that such buyer could meet both the power and losses/benefit criteria and would be required to consolidate the VIE.

5.3 **Examples**

The VIE model provides examples to illustrate the amended approach for determining the primary beneficiary. The following table summarizes these examples:

<table>
<thead>
<tr>
<th>Case</th>
<th>Description of structure</th>
<th>Primary beneficiary determination</th>
</tr>
</thead>
</table>
| A.   | Commercial mortgage-backed securitization (ASC 810-10-55-96 through 55-109) | An entity funds the purchase of commercial mortgage loans by issuing fixed rate debt with the same maturity to third-party investors and equity to a third-party who also performs the special servicing function. The transferor to the entity performs the primary servicing activities. Upon default of a mortgage loan, the administration of that loan is transferred to the special servicer. | The special servicer (who is also the equity holder) is deemed to be the primary beneficiary because:  
1. It meets the power criterion by managing the entity’s assets that are delinquent or in default, and through being able to approve budgets, leases, and the property managers of foreclosed properties.  
2. It meets the losses/benefits criterion by having the obligation to absorb losses through its equity investment. |
<table>
<thead>
<tr>
<th>Case</th>
<th>Description of structure</th>
<th>Primary beneficiary determination</th>
</tr>
</thead>
</table>
| B. Asset-backed collateralized debt obligation (ASC 810-10-55-110 through 55-121) | An entity funds the purchase of asset-backed debt securities by issuing two tranches of fixed rate debt to third party investors and equity (the equity is held by the manager and a third party investor). The manager earns both a fixed and a performance fee for managing the assets and can be removed by a majority of the debt holders. | The manager (who is also an equity holder) is deemed to be the primary beneficiary because:  
1. It meets the power criterion by managing the entity’s assets within certain parameters and removal rights are not held unilaterally by one party.  
2. It meets the losses/benefits criterion by having the obligation to absorb losses through its equity interest that could potentially be significant, as well as right to receive benefits that could potentially be significant through its performance-based fee. |
| C. Structured investment vehicle (ASC 810-10-55-122 through 55-133) | An entity funds the purchase of floating rate debt and short-term deposits by issuing short-term debt and equity to third party investors. Upon maturity of the debt, the entity will either refinance the debt with existing investors or reissue the debt to new investors. The sponsor performs the investment management, funding and defeasance management in return for a fixed and a performance fee. | The sponsor is deemed to be the primary beneficiary because:  
1. It meets the power criterion by managing the entity’s investment, funding, and defeasance activities, and sponsored the entity.  
2. It meets the losses/benefits criterion by receiving benefits that could potentially be significant to the entity through its performance-based fee arrangement and that it has an implicit financial responsibility (for reputation risk). |
### Case D. Commercial paper conduit (ASC 810-10-55-134 through 55-146)

<table>
<thead>
<tr>
<th>Description of structure</th>
<th>Primary beneficiary determination</th>
</tr>
</thead>
</table>
| An entity funds the purchase of a portfolio of medium-term assets by issuing short-term debt and subordinated notes to third party investors. Upon maturity of the debt, the entity will either refinance the debt with existing investors or reissue the debt to new investors. The sponsor provides credit enhancement in the form of a letter of credit, and a liquidity facility to fund cash flow shortages. The sponsor also establishes the terms of the entity, approves the transferors to the entity and the assets to be purchased, makes funding decisions, and administers the entity. The sponsor receives a fixed fee for providing these services. | The sponsor is deemed to be the primary beneficiary because:
1. It meets the power criterion by managing the entity’s investment, funding, and sponsored the entity.
2. It meets the losses/benefits criterion by having an obligation to absorb losses that could potentially be significant to the entity through its letter of credit and liquidity facility, and through its fee arrangement has the right to receive benefits that could potentially be significant to the VIE. |

### Case E. Guaranteed mortgage-backed securitization (ASC 810-10-55-147 through 55-159)

<table>
<thead>
<tr>
<th>Description of structure</th>
<th>Primary beneficiary determination</th>
</tr>
</thead>
</table>
| An entity funds the purchase of fixed-rate residential mortgage loans by issuing fixed rate debt with the same maturity to third-party investors. The entity enters into a guarantee facility that absorbs 100 percent of the credit losses on the loans. The loans acquired are underwritten by the transferor in accordance with the guarantor’s parameters. The guarantor serves as master servicer and is able to hire the primary servicer. Upon default of a mortgage loan, the primary servicer can propose a default mitigation strategy that the guarantor can approve, reject, or require another course of action. The guarantor receives a fixed fee. | The guarantor (who is also the master servicer) is deemed to be the primary beneficiary because:
1. It meets the power criterion in its role as master servicer (it can appoint and remove the primary servicer and direct default mitigation).
2. It meets the losses/benefits criterion by having the obligation to absorb losses through its guarantee that could potentially be significant. |
<table>
<thead>
<tr>
<th>Case</th>
<th>Description of structure</th>
<th>Primary beneficiary determination</th>
</tr>
</thead>
</table>
| F.   | Residential mortgage-backed securitization (ASC 810-10-55-160 through 55-171) | The transferor (who is also the primary servicer) is deemed to be the primary beneficiary because:  
1. It meets the power criterion by managing the entity’s assets that are delinquent or in default and no single party is able to remove the transferor as primary servicer.  
2. It meets the losses/benefits criterion by having the obligation to absorb losses that could potentially be significant through its residual tranche debt investment. |
| G.   | Property lease entity (ASC 810-10-55-172 through 55-181) | The lessee is deemed to be the primary beneficiary because:  
1. It meets the power criterion by maintaining and operating the property, and directing the remarketing of the property.  
2. It meets the losses/benefits criterion by having both the right to receive benefits through its purchase option and the obligation to absorb losses that could potentially be significant through the residual value guarantee. |
| H.   | Collaboration/joint venture arrangement (ASC 810-10-55-182 through 55-198) | In one instance, power is determined to be shared as both parties have power over the significant activities and are required to consent to decisions on those activities. In other situations, the two parties have power over the same activities but not shared power, or have power over different activities. |
### Identifying the primary beneficiary of a VIE

#### Case Description of structure

<table>
<thead>
<tr>
<th>Case</th>
<th>Description of structure</th>
<th>Primary beneficiary determination</th>
</tr>
</thead>
</table>
| I. Furniture manufacturing entity (ASC 810-10-55-199 through 55-205) | An entity is created to manufacture and sell wooded furniture and funded with equity from a furniture manufacturer and fixed-rate debt from a financial investor. The furniture manufacturer manages the day to day activities of the entity and has guaranteed the debt of the financial investor. | The furniture manufacturer is deemed to be the primary beneficiary because:  
1. It meets the power criterion by making all the ongoing operating decisions of the entity, and establishing the sales and marketing strategy.  
2. It meets the losses/benefits criterion by having both the right to receive benefits through its equity investment and the obligation to absorb losses that could potentially be significant through the debt guarantee. |
Chapter 6: Initial consolidation and subsequent accounting
Executive takeaway

- Initial measurement upon consolidation is largely based on ASC 805, *Business Combinations* (ASC 805), principles. However, there are few differences when the VIE and the primary beneficiary are under common control and when the VIE is not a business.

- Assets and liabilities transferred by the primary beneficiary to the VIE, at, after or shortly before the consolidation date should be recorded at historical book value with no gain or loss recognized.

- Subsequent consolidation and deconsolidation procedures generally follow the guidance in ASC 810, *Consolidation* (ASC 810).
6.1 Initial measurement and consolidation

Generally, the concepts underlying the accounting for the initial consolidation of a Variable Interest Entity (VIE) are similar to the concepts underlying the accounting for a newly acquired business under ASC 805. However, some nuances must be considered when:

- The VIE is not a business;
- A primary beneficiary transfers assets to the VIE at, after or shortly before the date it became the primary beneficiary; or
- The primary beneficiary of the VIE is under common control with the VIE.

6.1.1 Initial measurement upon consolidation of a VIE

The measurement upon the initial consolidation of a VIE by a primary beneficiary (except for those under common control) is addressed, as discussed below.

Excerpt from ASC 810-10

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.

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.
**VIE is a business**

When initially consolidating a VIE, the primary beneficiary should only recognize goodwill if the VIE is a business. ASC 805 provides the definition of a business (refer to section 1.2 of the PwC Guide: A Global Guide to Accounting for Business Combinations and Noncontrolling Interests: Application of the U.S. GAAP and IFRS Standards (BCG)). As specified in ASC 805, if the fair value of the consideration given is greater than the sum of the fair values of the identifiable net assets acquired, the result is goodwill. If the fair value of the consideration given is less than the sum of the fair values of the identifiable net assets acquired, the difference is considered a bargain purchase gain and is accounted for in accordance with ASC 805-30-25-2.

**VIE is not a business**

If the VIE is not a business the primary beneficiary will “recognize a gain or loss for the difference between (1) the fair value of any consideration paid, the fair value of any noncontrolling interests, and the reported amount of any previously held interests and (2) the net amount of the variable interest entity’s identifiable assets and liabilities recognized and measured in accordance with ASC 805. No goodwill shall be recognized if the variable interest entity is not a business.”

### 6.1.2 Asset and liability transfers from the primary beneficiary to the VIE

When consolidating a VIE, assets and liabilities transferred from the primary beneficiary to the VIE at, after, or shortly before the date the reporting entity became the primary beneficiary must be accounted for as discussed below.

**Excerpt from ASC 810-10-30-3**

...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.

The overriding principle is assets or liabilities transferred from a reporting entity to a VIE should not be remeasured if the reporting entity is the primary beneficiary. These transactions are viewed similar to transactions between entities under common control.

The assets and liabilities transferred should be measured at the amounts at which the assets and liabilities would have been measured if they had not been transferred. No gain or loss shall be recognized because of the transfer, even if the reporting entity was not the primary beneficiary until shortly after the transfer.
6.1.3 Common control

If the VIE is under common control, the primary beneficiary should reference the guidance in ASC 805 with regards to accounting principles governing transactions among parties under common control, as discussed below (refer to Appendix A of the PwC Guide: A Global Guide to Accounting for Business Combinations and Noncontrolling Interests: Application of the U.S. GAAP and IFRS Standards (BCG)).

Excerpt from ASC 810-10-30-1

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).

This paragraph requires that there be no remeasurement of a VIE’s assets and liabilities if the primary beneficiary and VIE are under common control. For example, assume Entity A and Reporting Entity B are under common control of Company XYZ (i.e., Company XYZ owns the majority of the voting common stock of each of these entities). Also assume that Reporting Entity B and Company XYZ each issue separate financial statements. Entity A is determined to be a VIE, and Reporting Entity B is identified as its primary beneficiary. Thus, following the guidance above, the net assets of Entity A would be recorded by Reporting Entity B at the amounts at which they are carried under GAAP in Company XYZ’s financial statements. The net assets would not be remeasured and thus, there would be no goodwill or gain or loss resulting from this transaction.

6.2 Accounting after initial measurement

Once the primary beneficiary initially consolidates a VIE, it will then account for the consolidated VIE in a manner that generally is consistent with the principles in ASC 810. However, there is one difference which relates to the ability to allocate intercompany profits between the parent (i.e., primary beneficiary) and noncontrolling interests.

Excerpt from ASC 810-10-35-3

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

After the initial consolidation of a VIE, the primary beneficiary should:

- Follow any specialized accounting requirements that apply to the type of business in which the VIE operates; and
- Follow ASC 810-10-45-21 which provides guidance on the elimination of intercompany balances and transactions, the allocation of intercompany profits and losses to noncontrolling interests, consideration of income taxes, changes in a parent’s (primary beneficiary) ownership interest, and deconsolidation.

### 6.2.1 Allocation of losses to noncontrolling interest holders

While the VIE model does not specifically address the manner in which losses should be allocated to noncontrolling interest holders, we believe the principles in ASC 810-10-45-21 apply. Such guidance requires that losses relating to the noncontrolling interest be charged to the noncontrolling interest.

### 6.2.2 Elimination of intercompany profits

**Excerpt from ASC 810-10-35-3**

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.

The first concept above is relatively straightforward. Intercompany fees between the primary beneficiary and VIE must be eliminated. When consolidating a VIE the guidance specifically states that the effect of the elimination of any net intercompany profit or loss may not be allocated to the noncontrolling interest. The FASB put this restriction to address situations where the primary beneficiary may not have an equity interest in the VIE. In such a situation, if allocation was allowed, the primary beneficiary would not record any income from fees earned from the VIE. Historically, while consolidation under the voting interest model permitted the allocation method, this method was, however, generally only utilized by investors applying the equity method of accounting.

The following examples illustrate the method that is required under the VIE model.
Example 1

Assumptions

Reporting Entity P purchases a 60 percent interest in Entity S for $120 cash (book value) at the beginning of the year. Entity S’s total capital is $200. Entity S is determined to be a VIE and Reporting Entity P is determined to be the primary beneficiary. During the year, Reporting Entity P sells goods to Entity S which are in Entity S’s inventory at year-end. The transaction results in a profit to Reporting Entity P as follows:

<table>
<thead>
<tr>
<th>Selling price</th>
<th>$100</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of sales</td>
<td>60</td>
</tr>
<tr>
<td></td>
<td>$40</td>
</tr>
</tbody>
</table>

No dividends were paid by Reporting Entity P and Entity S during the year. Reporting Entity P’s beginning retained earnings is zero.

Sales and expense information for Reporting Entity P and Entity S on a separate company basis, before giving effect to intercompany eliminations and noncontrolling interest income (expense), are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Reporting Entity P</th>
<th>Entity S</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$1,100</td>
<td>$300</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(660)</td>
<td>(200)</td>
</tr>
<tr>
<td></td>
<td>440</td>
<td>100</td>
</tr>
<tr>
<td>Selling and admin</td>
<td>176</td>
<td>30</td>
</tr>
<tr>
<td>Net income</td>
<td>$264</td>
<td>$70</td>
</tr>
</tbody>
</table>

Consolidation entries

Journal entries to record intercompany eliminations when the entire profit is eliminated and charged to Reporting Entity P’s interest for an entity that is not accounted for under the equity method:

Dr Capital stock—Entity S $120

Cr Investment in Entity S $120
To eliminate Reporting Entity P’s investment in Entity S.

**Dr Sales** $100

**Cr Cost of sales** $100

To eliminate intercompany sales.

**Dr Cost of sales** $40

**Cr Inventory** $40

To eliminate all intercompany profit in inventories at year end in accordance with the guidance in the VIE model.

**Dr Capital stock—Entity S** $80

**Dr Noncontrolling interest in income of Entity S** $28

**Cr Noncontrolling interest in Entity S** $108

To record initial noncontrolling interest in Entity S and the incremental noncontrolling interest share of net income of Entity S (note that the noncontrolling interest in income of Entity S is calculated as Entity S’s net income of $70 multiplied by the 40 percent noncontrolling interest in Entity S).

**Reporting Entity P’s share of income reported by Entity S** $42

**Adjustments to eliminate intercompany profits in inventory** (40)

**Equity in income of Entity S reported by Reporting Entity P** 2

**Income of Reporting Entity P** 264

**Consolidated net income** $266

As a result of the above entries, the following amounts result in the consolidated financial statements:

**Inventory** $60

**Noncontrolling interest** 108

**Consolidated retained earnings** $266
Example 2

Assumptions

Reporting Entity P makes a loan to Entity S and is a variable interest holder in Entity S. Reporting Entity P does not hold any voting interest in Entity S. The other variable interest holder in Entity S is its equity holder. Entity S is determined to be a VIE and Reporting Entity P is determined to be the primary beneficiary. During the year, Reporting Entity P charges Entity S $40 in interest. The consolidating adjustments and consolidated income statement of Reporting Entity P under the VIE model are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Reporting entity P</th>
<th>Entity S (VIE)</th>
<th>Adjustments</th>
<th>Consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>$1,060</td>
<td>$500</td>
<td></td>
<td>$1,560</td>
</tr>
<tr>
<td>Cost of revenues</td>
<td>(700)</td>
<td>(320)</td>
<td></td>
<td>(1020)</td>
</tr>
<tr>
<td>Operating income</td>
<td>360</td>
<td>180</td>
<td></td>
<td>540</td>
</tr>
<tr>
<td>Selling and administrative</td>
<td>(150)</td>
<td>(90)</td>
<td></td>
<td>(240)</td>
</tr>
<tr>
<td>Interest income</td>
<td>40</td>
<td>(40)</td>
<td></td>
<td>—</td>
</tr>
<tr>
<td>Interest expense</td>
<td></td>
<td>(40)</td>
<td>40</td>
<td>—</td>
</tr>
<tr>
<td>Net income</td>
<td>$250</td>
<td>$50</td>
<td>$0</td>
<td>$300</td>
</tr>
<tr>
<td>Net income attributable to non-controlling interest</td>
<td></td>
<td></td>
<td>$50</td>
<td>$50</td>
</tr>
<tr>
<td>Net income attributable to controlling interest</td>
<td>$250</td>
<td>$50</td>
<td>$(50)</td>
<td>$250</td>
</tr>
</tbody>
</table>

If the effects of the intercompany eliminations had instead been allocated to the non-controlling interest in proportion to equity ownership under the voting interest model, then the consolidating adjustments and consolidated income statement of Reporting Entity P under the voting interest model are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Reporting entity P</th>
<th>Entity S</th>
<th>Adjustments</th>
<th>Consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>$1,060</td>
<td>$500</td>
<td></td>
<td>$1,560</td>
</tr>
<tr>
<td>Cost of revenues</td>
<td>(700)</td>
<td>(320)</td>
<td></td>
<td>(1020)</td>
</tr>
<tr>
<td>Operating income</td>
<td>360</td>
<td>180</td>
<td></td>
<td>540</td>
</tr>
</tbody>
</table>
Initial consolidation and subsequent accounting

<table>
<thead>
<tr>
<th>Selling and administrative</th>
<th>Reporting entity P</th>
<th>Entity S</th>
<th>Adjustments</th>
<th>Consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(150)</td>
<td>(90)</td>
<td></td>
<td>(240)</td>
</tr>
<tr>
<td>Interest income</td>
<td>40</td>
<td>(40)</td>
<td></td>
<td>—</td>
</tr>
<tr>
<td>Interest expense</td>
<td></td>
<td>(40)</td>
<td>40</td>
<td>—</td>
</tr>
<tr>
<td>Net income</td>
<td>$250</td>
<td>$50</td>
<td>$0</td>
<td>$300</td>
</tr>
</tbody>
</table>

Net income attributable to non-controlling interest

<table>
<thead>
<tr>
<th>Net income attributable to controlling interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>$250</td>
</tr>
</tbody>
</table>

Thus, under the voting interest model, $90 of net income is attributed to the non-controlling interest and $210 to Reporting Entity P. However, because Entity S is consolidated pursuant to the VIE model, Reporting Entity P’s net income remains unchanged as the effect of the interest income eliminated in consolidation has been attributed entirely to the primary beneficiary (see below):

<table>
<thead>
<tr>
<th>Under voting interest model</th>
<th>Under VIE model</th>
</tr>
</thead>
<tbody>
<tr>
<td>Separate net income of Reporting Entity P</td>
<td>$250</td>
</tr>
<tr>
<td>Interest income attributed to non-controlling interest</td>
<td>40</td>
</tr>
<tr>
<td>Net income attributable to controlling interest</td>
<td>$210</td>
</tr>
</tbody>
</table>

6.2.3 Deconsolidation

Excerpt from ASC 810-10-40-4:

A parent shall deconsolidate a subsidiary or derecognize a group of assets specified in the preceding paragraph as of the date the parent ceases to have a controlling financial interest in that subsidiary or group of assets. See paragraph 810-10-55-4A for related implementation guidance.

Excerpt from ASC 810-10-55-4A:

All of the following are circumstances that result in deconsolidation of a subsidiary under paragraph 810-10-40-4:
a. A parent sells all or part of its ownership interest in its subsidiary, and as a result, the parent no longer has a controlling financial interest in the subsidiary.

b. The expiration of a contractual agreement that gave control of the subsidiary to the parent.

c. The subsidiary issues shares, which reduces the parent’s ownership interest in the subsidiary so that the parent no longer has a controlling financial interest in the subsidiary.

d. The subsidiary becomes subject to the control of a government, court, administrator, or regulator.

Refer to BCG 6.6 for more guidance with respect to deconsolidation.

### 6.3 Questions and interpretive responses

#### Initial measurement and consolidation

**Question 6-1**

What guidance applies to the transfer of net assets between a VIE and another entity that are under common control?

**PwC response**

ASC 805-50-30-5 applies to transfers of net assets between entities under common control. Under that guidance, the transfer of net assets results in a change in the reporting entity. Per ASC 805-50-05-5, the accounting for the transfer is reflected in a manner similar to a pooling of interests. Also, ASC 805-50-45-2 states that the transferee’s financial statements should report results of operations for the period in which the transfer occurs as though the transfer of assets occurred at the beginning of the period. The restatement of prior period financial statements on a combined basis would be as of the date the VIE and the other entity came under common control.

**Question 6-2**

How does a reporting entity that is determined to be the primary beneficiary of a VIE account for the VIE’s activities in its consolidated financial statements if the reporting entity does not have an equity investment in the entity?

**PwC response**

The primary beneficiary must consolidate 100 percent of the balance sheet and income statement of the VIE and should generally apply normal consolidation procedures as if it were the parent in a normal parent-subsidiary relationship. The equity interests held by other parties in the VIE should be reflected as noncontrolling
interest. (ASC 323-10-35 and 10-55 may be useful in these situations, as may be the hypothetical liquidation at book value.)

**Question 6-3**

If a reporting entity consolidates an entity which is a business and is not under common control upon the adoption of the VIE model, should the consolidation be carried out under ASC 805?

**PwC response**

A reporting entity should use applicable GAAP at the time of consolidation of an entity under the VIE model. The initial consolidation of a variable interest entity that is a business and not under common control is treated as a business combination. Therefore, if FAS 141 (which has since then been superseded by ASC 805 (FAS 141(R)) was applicable at the time of consolidation, then the consolidation would be effected using the guidance under FAS 141 (i.e., amounts would be allocated to assets and liabilities using the purchase price allocation model in FAS 141 and the minority interest would be fair valued). If however ASC 805 (FAS 141(R)) was applicable at the time of consolidation, then the consolidation would be effected using the guidance under ASC 805 (FAS 141(R)) i.e., amounts would be allocated to assets and liabilities using the purchase price allocation model in ASC 805 (FAS 141(R)) and the noncontrolling interest would be fair valued.

**Accounting after initial measurement**

**Question 6-4**

If a primary beneficiary consolidates a VIE under the VIE model, can the consolidated balance sheet show a negative noncontrolling interest position (debit balance) if the subsidiary generates losses that would cause the noncontrolling interest balance to drop below zero?

**PwC response**

Under ASC 810, the parent (primary beneficiary) should show a negative noncontrolling interest position (debit balance) related to its consolidated subsidiary if the consolidated subsidiary generates losses that would cause the noncontrolling interest balance to drop below zero. That is, the noncontrolling interest should continue to be attributed its share of losses even if that attribution results in a deficit noncontrolling interest balance. Any losses that were previously attributed to the parent because those losses exceeded the noncontrolling interest investment in the subsidiary should remain attributable to the parent and not be re-attributed to the non-controlling interest.

The VIE model does not change this guidance regarding noncontrolling interest balances. ASC 810-10-35-3, "the principles of consolidated financial statements in this Topic apply to primary beneficiaries’ accounting for consolidated variable interest entities (VIEs). After the initial measurement, the assets, liabilities and noncontrolling
interests of a consolidated VIE shall be consolidated as if the VIE were consolidated based on voting interests.”

**Question 6-5**

If a subsidiary generates losses that would cause the noncontrolling interest balance in the consolidated balance sheet to be reduced below zero, but the parent company determines that the fair value of its subsidiary is greater than book value, should the consolidated balance sheet show a negative noncontrolling interest position (debit balance) related to the subsidiary?

**PwC response**

Yes. The parent should show a negative noncontrolling interest position (debit balance) related to its subsidiary if its subsidiary generates losses that would cause the noncontrolling interest balance to drop below zero.

Under ASC 810, losses attributable to the parent and the noncontrolling interest in a subsidiary may exceed their interests in the subsidiary’s equity. The excess, and any further losses attributable to the parent and the noncontrolling interest, shall be attributed to those interests. That is, the noncontrolling interest shall continue to be attributed its share of losses even if that attribution results in a deficit noncontrolling interest balance.

Accordingly, the parent is required to allocate losses to noncontrolling interest even after the noncontrolling interest balance is reduced to zero since this conclusion is not based on whether or not the fair value of the noncontrolling interest is greater than its book value. ASC 810 does not specify any particular method for attributing earnings between controlling and noncontrolling interests. If there are contractual arrangements that determine the attribution of earnings, such as a profit sharing arrangement, then the attribution specified by the arrangement is used. If there are no such contractual arrangements, then the relative ownership interest should be used as the basis for attribution of earnings between controlling and noncontrolling interests.

**Question 6-6**

If the equity holders of a VIE are also employees of the primary beneficiary, how should the VIE’s distributions to those equity holders be reflected in the consolidated financial statements?

**PwC response**

Depending on the facts and circumstances, such distributions could be considered as being compensatory (therefore requiring expense recognition) or, could be considered no different than what an independent investor would receive. The following factors are indicative of the distributions being similar to those that an independent investor would receive:

- Real value for value cash payment (i.e., the relationship between invested capital and distributions should be considered).
There is no linkage between the distributions to be made and the employment of the common shareholders of the VIE.

Distributions are *pari passu* with each investor’s ownership interest.

Distributions are made to all residual equity holders of the entity.

There are no agreements between the primary beneficiary and the residual equity holders that expressly guarantee distribution to the investors.

The noncontrolling interests qualify for equity classification under applicable GAAP.

**Question 6-7**

How does a primary beneficiary of a VIE record the acquisition of the variable interests held by the entity’s noncontrolling interest holders?

Consider the following fact pattern:

Parent became the primary beneficiary of a variable interest entity (Entity A) on October 1, 2010. Parent initially consolidated Entity A by recognizing the fair value of the assets, liabilities and noncontrolling interests as of the date it became the primary beneficiary in accordance with ASC 810-10-30-2 through 30-6. The noncontrolling interest was legal form equity in the form of common stock and represented Entity A’s residual interest (i.e., it was not preferred stock or a liability).

On March 2, 2011, Parent acquires all of the outstanding common shares of Entity A held by the noncontrolling shareholders and becomes the 100 percent owner of the common stock of Entity A.

**PwC response**

The acquisition of the noncontrolling interest should be accounted for pursuant to existing GAAP, which in this case should be reflected as an equity transaction as a result of the acquisition of the outstanding noncontrolling interest in accordance with ASC 810-10-45-23 as there was no change in control.

**Question 6-8**

When a variable interest entity is de-consolidated by a primary beneficiary (either because the VIE is no longer a VIE or the primary beneficiary is no longer the primary beneficiary of the VIE), can the primary beneficiary report the variable interest entity as discontinued operations under ASC 360, *Property, Plant, and Equipment* (ASC 360)?

**PwC response**

A primary beneficiary should report the de-consolidation of a variable interest entity as discontinued operations if the variable interest entity satisfies the requirements in ASC 205-20-45-1 through 45-2.
Question 6-9
If a primary beneficiary of a VIE constructs an asset which qualifies for interest capitalization under ASC 835, Interest (ASC 835) specifically ASC 835-20-15-5, and the VIE has external debt on which it pays interest expense, can the consolidated group utilize the VIE’s interest expense to perform its capitalization of interest under ASC 835-20-30-6?

PwC response
Yes. ASC 835-20-30-6 applies to entities consolidated under both the voting interest model and the variable interest model. ASC 835-20-30-6 also applies in cases where a primary beneficiary has a 0 percent equity ownership interest in its consolidated VIE.

ASC 835-20-25-3 requires the capitalization of interest in instances where an asset requires a period of time to bring it to the condition and location necessary for its intended use. ASC 835-20-30-6 states that “the total amount of interest cost capitalized in an accounting period shall not exceed the total amount of interest cost incurred by the entity in that period. In consolidated financial statements, that limitation shall be applied by reference to the total amount of interest cost incurred by the parent entity and consolidated subsidiaries on a consolidated basis.”

Under ASC 835, there is no requirement that the interest cost incurred by one entity in a consolidated group has to be related to the other entity in the group that is capitalizing the interest cost (such as a source and use of funds relationship). In essence, there is no cash flow linkage requirement between the two entities, other than both entities being a part of the same consolidated group.
Chapter 7: Presentation and disclosure requirements
7.1 Disclosure

Guidance can now be found in FSP 18.

7.2 Presentation

Guidance can now be found in FSP 18.

7.3 “Information-out” scope exception

Guidance can now be found in FSP 18.

7.4 Item 2.01 form 8-K and rule 3-05 reporting requirements

At the 2003 AICPA National Conference on Current SEC Developments, several topics were discussed in relation to the interaction between the VIE model and the Form 8-K requirements. The SEC Staff addressed potential reporting requirements under Item 2.01 of Form 8-K and under Regulation S-X Rule 3-05 that could be triggered by the VIE model. Registrants are generally required to file an Item 2.01 of Form 8-K if they (or a majority-owned subsidiary) acquire or dispose of a significant amount of assets in circumstances other than in the ordinary course of business (refer to VE 8.1.7 for a discussion of the disclosure requirements at transition). For purposes of reporting under Item 2.01 of Form 8-K, an “acquisition” includes “every purchase, acquisition by lease, exchange, merger, consolidation, succession or other acquisition....”

At the 2003 Conference, the SEC Staff indicated that it was still contemplating how these reporting requirements relate to VIEs. A final model was never published. Nevertheless, at the 2003 Conference, the SEC Staff indicated that in cases other than the initial adoption of the VIE model, the consolidation or deconsolidation of a VIE generally would trigger the need to consider the Form 8-K reporting requirements. The SEC Staff listed several factors that should be considered to determine if it would be necessary to file a Form 8-K:

□ The form of the reporting entity’s variable interest in the entity (for example, an asset, obligation, or executory contract).

□ Whether the event occurred in the ordinary course of business.

□ The significance thresholds within Form 8-K.

□ Whether the VIE is a business (as defined under Rule 11-01(d) of Regulation S-X).

With respect to acquisitions, if the VIE is a business and is significant, audited financial statements and pro forma financial statements will be required under Item 9.01 of Form 8-K and under Rule 3-05. If the disposition of a VIE, that is a business is significant, pro forma financial statements reflecting the disposition would be required. The Center of Audit Quality (CAQ) SEC Regulations Committee discussed
this topic with the SEC staff. In that discussion, the SEC staff indicated that in cases other than the initial adoption of the variable interest entity consolidation accounting standard, the consolidation or deconsolidation of a VIE would trigger the need to consider Item 2.01 Form 8-K reporting requirements. The reporting thresholds and requirements vary based on whether the variable interest entity is a business (as defined under S-X 11-01(d)) and the significance thresholds under S-X 1-02(w). If the VIE is a business and significant above the 20 percent level, the SEC staff believes that the Item 2.01 Form 8-K must include S-X Rule 3-05 financial statements under Item 9.01 of Form 8-K, as well as pro forma financial information under S-X Article 11. If the VIE is not a business, the consolidation should be regarded as an asset acquisition and reported under Item 2.01 of Form 8-K if it exceeds the applicable 10 percent significance test and the need for pro forma information under Item 9.01 should also be considered.

A registrant must also consider whether it has a Form 8-K reporting obligation if a reconsideration event results in deconsolidation of a VIE.

Finally, the SEC staff has not indicated how the timing of these reporting requirements relates to the consolidation of a variable interest entity. The SEC staff has yet to clarify the filing and timing requirements of the Form 8-K, whether it must be filed within four business days of the reconsideration event, and the implications to a registrant’s eligibility to use Form S-3.

7.5 Questions and interpretive responses

Guidance can now be found in FSP 18.
Chapter 8: Transition upon adoption and effective date
Transition upon adoption and effective date

Executive takeaway

☐ The revised VIE model (as amended by ASU 2009-17) is effective as of the beginning of a reporting entity’s first fiscal year beginning after November 15, 2009, and for interim periods within that first period. Earlier adoption was prohibited.

☐ There was no grandfathering—the VIE model as amended by ASU 2009-17 must be applied to all entities including those that previously met the requirements to be Qualified Special Purpose Entities (QSPEs). See VE 2.3 for the deferral of the VIE model (as amended by ASU 2009-17) for certain investment entities.

☐ In transition, the initial measurement of the assets, liabilities and non-controlling interests of a newly consolidated VIE is based on the amounts that would have been carried in the consolidated financial statements when the reporting entity first became the primary beneficiary as if the VIE model as amended by ASU 2009-17 had been effective all along. If it is not practicable to determine these amounts, then such amounts can be based on fair value at adoption date (or the unpaid principal balances for securitizations or other forms of asset-backed financings).

☐ A reporting entity which availed itself of the “information-out” scope exception but must now consolidate because the scope exception is no longer available (i.e., the information is now available) may follow the VIE model as amended by ASU 2009-17 transition guidance and not restate.

☐ To the extent that an entity qualified for the deferral in ASU 2010-10 but no longer qualifies, the guidance in this chapter would apply.
8.1 Transition upon adoption of the VIE model as amended by ASU 2009-17

This chapter discusses key points that should be considered upon the adoption of the VIE model including:

□ Initial application—Transition guidance
□ Fair value and unpaid principal balance practicability exception
□ Deconsolidation
□ Fair value option
□ “Information-out” scope exception
□ Treatment of pre-existing hedge relationships upon transition
□ Transitional disclosure requirements
□ SEC considerations

See VE 2.3 for the deferral of VIE Model as amended by ASU 2009-17 for certain investment entities.

8.1.1 Initial application — Transition guidance

Excerpt from ASC 810-10-65-2

b: If a reporting entity is required to consolidate a VIE 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 VIE 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 be the primary beneficiary.

1. If determining the carrying amount is practicable, the consolidating entity shall initially measure assets, liabilities, and noncontrolling interests of the VIE at their carrying amounts at the date the requirements of the pending content that links to this paragraph first apply.

2. 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 pending content that links to this paragraph first applies. 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 pending content that links to this paragraph first applies if both of the following conditions are met:
i. The activities of the VIE are primarily related to securitizations or other forms of asset-backed financings.

ii. The assets of the VIE can be used only to settle obligations of the entity.

This measurement alternative 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.

c: 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 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.

f: The determinations of whether a legal entity is a VIE and which reporting entity if any, is a VIEs primary beneficiary shall be made as of the date the reporting entity became involved with the legal entity or if events requiring reconsideration of the legal entity's status or the status of its variable interest holders have occurred, as of the most recent date at which the pending content in the Variable Interest Entities Subsection, would have required consideration.

g: If at transition it is not practicable for a reporting entity to obtain the information necessary to make the determinations in (f) above as of the date the reporting entity became involved with a legal entity or at the most recent reconsideration date, the reporting entity should make the determinations as of the date on which the pending content in the Variable Interest Entities Subsection is first applied.

h: If the VIE and primary beneficiary determinations are made in accordance with subparagraphs (f) and (g) above, then the primary beneficiary shall measure the assets, liabilities, and noncontrolling interests of the VIE at fair value as of the date on which the pending content in the Variable Interest Entities Subsections is first applied. However, if the activities of the VIE are primarily related to securitizations or other forms of asset-backed financings and the assets of the VIE can be used only to settle obligations of the VIE, then the assets and liabilities of the VIE may be measured at their unpaid principal balances (as an alternative to a fair value measurement) at the date the pending content in the Variable Interest Entities Subsections first applies. This measurement alternative 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.
On adoption, the VIE model as amended by ASU 2009-17 provides several alternatives:

- Retrospectively apply the guidance through a cumulative-effect adjustment to retained earnings as of the beginning of the first year presented. A reporting entity that has previously not applied the VIE model because of the inability to obtain the information necessary to (1) determine whether the entity is a variable interest entity, (2) determine whether the reporting entity is the variable interest entity’s primary beneficiary, or (3) perform the accounting required to consolidate the variable interest entity for which it is determined to be the primary beneficiary but subsequently obtains the information necessary to apply the amended guidance to that entity should apply the provisions of the amended VIE model as of the date the information is acquired.

- Apply the guidance as of the date of adoption through a cumulative-effect adjustment to the opening balance of retained earnings in the year of adoption.

If a reporting entity decides to retrospectively apply the guidance, it is important to note that the amended guidance would need to be applied retrospectively to all instances in which a reporting entity has a variable interest in an entity and not just to those variable interests in existence at the adoption date. For example, Company A reports on a calendar year-end basis with three years of financial information presented in its financial statements and will adopt the amended guidance on January 1, 2010, on a retrospective basis. During 2008, Company A acquired a variable interest in a variable interest entity, which would have caused Company A to be its primary beneficiary. However, during 2009 Company A disposed of its variable interest and would no longer be considered the primary beneficiary of the entity. Despite Company A not holding a variable interest in the entity at the January 1, 2010, adoption date, Company A must include the effects of consolidation in 2008 and deconsolidation in 2009 when applying the amended guidance on a retrospective basis.

For VIEs that require consolidation due to the application of the VIE model as amended by ASC 2009-17, reporting entities are required (unless eligible for the practicability exception discussed in VE 8.1.2) to recognize and measure the consolidated elements at their carrying values as if they had been consolidated when the reporting entity first became the primary beneficiary under the VIE model as amended by ASU 2009-17. The term *carrying amount* does not refer to the current book value or historical cost basis of the assets, liabilities and noncontrolling interests of the VIE. In this context, carrying amount refers to the fair value of the assets, liabilities and noncontrolling interests at the date the reporting entity first would have been the primary beneficiary (had the amended VIE model been effective at that time), carried forward to the adoption date. In other words, carrying value is the fair value as adjusted by any accounting entries that would have been recorded between the date the reporting entity first became the primary beneficiary and the date of adoption.

The initial transition of the VIE model as amended by ASU 2009-17 can be very cumbersome since all transactions that have occurred between the date the reporting entity first became the primary beneficiary and the adoption date would need to be
recognized. This would include analysis of any impairment of assets, intangibles or goodwill and could change goodwill impairment testing for reporting units when the reporting entity consolidated the entity as its primary beneficiary. Establishing the appropriate date to determine whether or not an entity is a VIE and which reporting entity, if any, is the VIE's primary beneficiary can also be challenging since the reporting entity is required to work backwards from the adoption date and consider all prior VIE reconsideration events and other changes to the primary beneficiary determination during the period.

**EXAMPLE 8-1**

Company XYZ is required to adopt the VIE Model as amended by ASU 2009-17 on January 1, 2010. Company XYZ has elected to not apply the guidance on a retrospective basis and therefore will recognize a cumulative effect adjustment to retained earnings on January 1, 2010. Company XYZ acquired a 40 percent equity interest in Entity V on June 1, 2008. On April 15, 2009, Entity V went through a major restructuring of its business and it has been determined that such event qualified as a VIE reconsideration event. On August 1, 2009, Company XYZ acquired an additional 10 percent equity interest in Entity V from another investor in Entity V bringing Company XYZ's ownership interest in Entity V to 50 percent. Company XYZ has been accounting for its interest in Entity V under the equity method of accounting.

In determining whether Company XYZ is required to consolidate Entity V at the adoption date, Company XYZ would need to first consider whether or not Entity V is a VIE at the last VIE reconsideration event on April 15, 2009.

If the entity is not a VIE on April 15, 2009, then Company XYZ would not be required to consolidate under the VIE model as amended by ASU 2009-17 and there would be no cumulative effect adjustment because Company XYZ elected to not apply the amended VIE model on retrospective basis.

If Entity V is **first** determined to be a VIE at April 15, 2009, and there was no VIE reconsideration event after April 15, 2009, then Company XYZ would assess whether it is the primary beneficiary on January 1, 2010 (its adoption date) and when it first became the primary beneficiary. If it is determined that Company XYZ became the primary beneficiary on August 1, 2009, (and was not the primary beneficiary from April 15, 2009 through August 1, 2009) as a result of additional power granted it through its 10 percent additional equity acquisition, then in determining the cumulative effect adjustment, Company XYZ would consolidate Entity V on August 1, 2009, and roll forward its accounting elements as if Entity V had been consolidated since August 1, 2009. Note that if Company XYZ had VIE reconsideration events prior to April 15, 2009, Company XYZ would need to go back to all such prior VIE reconsideration event dates to determine the periods when Company XYZ was the primary beneficiary when Entity V was a VIE under the VIE model as amended by ASU 2009-17.
8.1.2  **Fair value and unpaid principal balance practicability exception**

The VIE model as amended by ASU 2009-17 allows a reporting entity to initially measure the consolidated elements at fair value as of the date the amended VIE model first applies if ascertaining the carrying value is not practicable on the adoption date. In addition, the VIE model (as amended by ASU 2009-17) also allows the unpaid principal balance to be used as a practicability exception if the activities of the entity are primarily related to securitization or other forms of asset-backed financing and the assets of the entity can be used only to settle the obligations of the entity. This measurement alternative does not eliminate the need for the primary beneficiary to recognize any accrued interest, allowance for credit losses, or other-than-temporary impairment.

The Board intends for these additional transition measurement alternatives to be utilized only in scenarios in which a reporting entity would need to incur an excessive amount of cost and effort to determine the carrying amounts as described above. The Board believes that the unpaid principal balance measurement alternative is acceptable since a fair value measurement upon consolidation with no ongoing fair value measurement requirement would not reflect the primary beneficiary’s exposure to the activities of the consolidated variable interest entity and that the unpaid principal balance in these circumstances still provides useful information to financial statement users. However, fair value must be used if a consolidated element does not have an unpaid principal balance or if fair value is required under other applicable GAAP.

8.1.3  **Deconsolidation**

**Excerpt from ASC 810-10-65-2(e)**

If a reporting entity is required to deconsolidate a VIE as a result of the initial application of the pending content in the Variable Interest Entities Subsections, the deconsolidating reporting entity shall initially measure any retained interest in the deconsolidated subsidiary at its carrying amount at the date the requirements of the pending content in the Variable Interest Entities Subsections first apply. 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 in the Variable Interest Entities Subsection had been effective when the reporting entity became involved with the VIE or no longer met the conditions to be the primary beneficiary. Any difference between the net amount removed from the balance sheet of the deconsolidating reporting entity and the amount of any retained interest in the newly deconsolidated VIE shall be recognized as a cumulative effect adjustment to retained earnings. The amount of any cumulative effect adjustment related to deconsolidation shall be disclosed separately from any cumulative effect adjustment related to consolidation of VIEs.

Certain VIEs may need to be deconsolidated due to the application of the VIE model as amended by ASU 2009-17. If a reporting entity is required to deconsolidate a VIE, the deconsolidating reporting entity shall initially measure any retained interest in the deconsolidated subsidiary at its carrying amount as of the date the VIE model as
amended by ASU 2009-17 first applies (either the date of adoption or the beginning of the first period presented, depending on which transition method is selected). Any differences between the net amount removed from the balance sheet with respect to the deconsolidated entity and the amount of any retained interest in the newly deconsolidated entity will be recognized as a cumulative effect adjustment to the opening balance of 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 entities.

Note that the date of the deconsolidation will make a difference in the transition accounting. If a reporting entity concludes that it was not the primary beneficiary under the VIE model as amended by ASU 2009-17 since inception, then it is as if the reporting entity would not have ever consolidated the VIE. Therefore, when considering the accounting at inception, there is no deconsolidation transaction—rather it should be accounted for as an investment. However, if under the VIE model as amended by ASU 2009-17, the reporting entity is the primary beneficiary at inception and then ceases to be the primary beneficiary at a later date, than a deconsolidation transaction has occurred. In this case, the VIE will be consolidated for a period of time under the VIE model as amended by ASU 2009-17 and then be deconsolidated at a later date based on the deconsolidation guidance in effect at the time of the deconsolidation.

**EXAMPLE 8-2**

At inception on January 15, 2008, Company A and B invested $100 million each for a 50 percent common stock ownership interest in a new entity “VIE.” Company A was the primary beneficiary under the prior VIE model because it guaranteed the VIE’s external bank debt and therefore consolidated the VIE. Company A adopted the VIE model as amended by ASU 2009-17 effective January 1, 2010.

As a result of adoption of the VIE model as amended by ASU 2009-17, Company A concludes that, at both at inception of the VIE and on an ongoing basis, Company B has the power to direct activities that significantly impact the economic performance of the VIE. Therefore, under the amended VIE model, Company B and not Company A is the primary beneficiary both at inception and through the period up until adoption of the VIE model as amended by ASU 2009-17. In applying ASC 323, Company A will record a $105 million equity method investment at January 15, 2008, representing both the cash it contributed ($100 million) and the fair value of its guarantee of VIEs debt ($5 million). This equity method investment will then be rolled forward to December 31, 2009, considering its proportionate share of equity earnings, any change in interest transactions, as well as amortization or accretion of any basis differences. Additionally, the guarantee liability would also be rolled forward. The equity method investment rolled forward balance coupled with the liability recognized for the guarantee of debt will then be compared to the net assets of the VIE to be deconsolidated at adoption date to determine the cumulative effect upon adoption of the VIE model as amended by ASU 2009-17.
EXAMPLE 8-3

At inception on January 15, 2008, Company A and B invested $100 million each for a 50 percent common stock ownership interest in a VIE. Company A has the power to appoint and remove a majority of the VIE’s board of directors. On January 15, 2009, Company B entered into a manufacturing arrangement with the VIE which gave Company B additional board seats and as a result, Company B obtained control of the board of directors (therefore, Company B obtained the power over activities that most significantly impact the economic performance of the VIE). Company A was the primary beneficiary under the prior VIE model because it absorbed a majority of the VIE’s expected losses (through its 50 percent equity investment and it guarantee of the VIE’s external bank debt) and therefore consolidated the VIE. Company A adopted the VIE model as amended by ASU 2009-17 effective January 1, 2010.

Upon adoption of the VIE model as amended by ASU 2009-17, Company A concludes that it is still the primary beneficiary at inception because it has the power to appoint and remove a majority of the VIE’s board of directors and therefore has the power to direct the activities that significantly impact the economic performance of the VIE. However, on January 15, 2009, when Company B enters into a manufacturing arrangement with the VIE, the power shifts from Company A to Company B. Therefore, under the VIE model as amended by ASU 2009-17, Company A will consolidate the VIE from January 15, 2008, onwards and will deconsolidate the VIE on January 15, 2009. Upon deconsolidation, Company A’s retained interest or equity method investment (and its guarantee of the external debt) will be recorded at fair value based upon ASC 810, the guidance in effect in 2009. The equity method investment will then be rolled forward to December 31, 2009, considering its proportionate share of equity earnings, any change in interest transactions, as well as amortization or accretion of any basis differences. The equity method investment rolled forward balance will then be compared to the net assets to be deconsolidated at adoption date to determine the impact upon adoption of the VIE model as amended by ASU 2009-17.

8.1.4 Fair value option

Excerpt from ASC 810-10-65-2(d)

A reporting entity that is required to consolidate a VIE as a result of the initial application of the pending content in the Variable Interest Entities subsections may elect the fair value option provided by the Fair Value Option Subsections of Subtopic 825-10, only if the reporting entity elects the option for all financial assets and financial liabilities of that VIE that are eligible for this option under those Fair Value Option Subsections. This election shall be made on a VIE-by-VIE basis. Along with the disclosures required in those Fair Value Option Subsections, the consolidating reporting entity shall disclose all of the following:

1. Management’s reasons for electing the fair value option for a particular VIE or group of VIEs.
2. The reasons for different elections if the fair value option is elected for some VIEs 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 VIE.

While the VIE model as amended by ASU 2009-17 does not generally provide accounting guidance for subsequent measurement of consolidated elements, a reporting entity that is required to consolidate an entity as a result of the initial application of the VIE model as amended by ASU 2009-17 may elect the fair value option under the Fair Value Option Subsections of ASC 825. However, at the transition date a reporting entity must elect the fair value option on an entity by entity basis and apply the fair value option to all elements of the entity eligible under the Fair Value Option Subsections of ASC 825. This is different from the provisions of the Fair Value Option Subsections of ASC 825 that allow for an instrument-by-instrument election. Note that this discussion applies only to the initial adoption of the VIE model as amended by ASU 2009-17 and not to its subsequent application. A reporting entity that elects the fair value option will need to provide the disclosures under the Fair Value Option Subsections of ASC 825 and also describe its rationale for electing the fair value option for certain entities.

8.1.5 “Information-out” scope exception

Excerpt from ASC 810-10-30-7

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.

The Board expects a reporting entity to continue to make exhaustive efforts to obtain the necessary information to apply the provisions of the VIE model. See VE 2.2.6 for more details regarding the “information out” scope exception.

8.1.6 Treatment of pre-existing hedge relationships upon transition

Pre-Codification DIG Issue E22 addresses how a pre-existing hedge relationship should be treated upon the consolidation (or the deconsolidation) of another entity upon the adoption of the VIE model as amended by ASU 2009-17. At issue is the treatment or de-designation of a pre-existing hedge relationship that is designated as a hedge under Accounting Standards Codification 815, Derivatives and Hedging (ASC 815) upon the application of the VIE model as amended by ASU 2009-17. Although DIG Issue E22 related to the initial application of the prior VIE model (FIN 46 or FIN 46(R)) and is not included in the FASB Codification, we believe the concepts in DIG Issue E22 are relevant to the initial application of the amended VIE model.
Excerpt from DIG Issue E22 (pre-Codification)

If a reporting entity is required to discontinue a pre-existing hedging relationship upon the initial application of Interpretation 46 or 46(R) due to the required consolidation of another entity in (or the deconsolidation of that entity from) the reporting entity’s consolidated financial statements, the adjustments of the reporting entity’s financial statements must reflect the ongoing effect of the previous hedge accounting for those discontinued relationships in a manner consistent with the reporting entity’s risk management policy and the objectives of those discontinued hedging relationships. Reflecting that ongoing effect of those discontinued relationships will involve identification and designation of surrogate hedged items for discontinued fair value hedges and surrogate hedged forecasted transactions for discontinued cash flow hedges. The surrogate hedged items and hedged forecasted transactions would need to have met (on a retroactive basis) the qualifying criteria applicable to those items and transactions (other than the requirement for contemporaneous documentation).

The identification of surrogate hedged items and hedged transactions relates solely to reflecting the ongoing effect of the discontinued hedging relationships, that is, how the basis adjustments arising from fair value hedge accounting and the amounts in OCI arising from cash flow hedge accounting should affect earnings in future periods.

In addition, if the initial application of the VIE model as amended by AU 2009-17 causes the discontinuance of a pre-existing hedging relationship for which effectiveness was being assessed under the shortcut method in ASC 815-20-25-10 through 25-11 and the reporting entity designates a new hedging relationship, the new hedging relationship can qualify for the shortcut method if the criteria described in pre-Codification DIG Issue E22 are met.

The guidance in pre-Codification DIG Issue E22 does not affect the designation of new hedging relationships on or after the date of initial application of the VIE model as amended by ASU 2009-17. Such new hedging relationships need to comply with all applicable requirements of ASC 815 except with respect to the special use of the shortcut method, as previously discussed.

8.1.7 Transitional disclosure requirements

Excerpt from ASC 810-10-65-2:

For public entities, in periods after initial adoption, comparative disclosures for those disclosures that were not previously required by paragraphs 810-10-50-7 through 50-19 are required only for periods after the effective date. Comparative information for disclosures previously required by those paragraphs that are also required by the pending content in the Variable Interest Entities Subsections shall be presented. For non-public entities, in periods after initial adoption, comparative disclosures for those disclosures that were not previously required by are required only for periods after the effective date. Comparative information for disclosures previously required that are also required by the pending content in the Variable Interest Entities Subsections shall be presented.
All reporting entities are required to provide the disclosures for interim and annual reporting periods ending after the date of adoption. Comparative information is encouraged (but not required) for periods in which these disclosures were not already required.

A reporting entity will have to describe the transition method applied and disclose the amount and classification of the consolidated assets or liabilities in its balance sheet impacted by adopting the VIE model as amended by ASU 2009-17.

### 8.1.8 SEC considerations

The SEC staff shared with the Center for Audit Quality SEC Regulations Committee its views on the following practice issues with respect to the VIE model as amended by ASU 2009-17:

**Filing Registration Statements After Adoption of the VIE Model as amended by ASU 2009-17**

The SEC staff has indicated that if a reporting entity has elected to adopt the VIE model retrospectively and has filed interim financial statements for a period that includes the date of adoption, that registrant must recast its prior period annual financial statements that are incorporated by reference to reflect a material retrospective application of the VIE model. Conversely, if a registrant elects to adopt the VIE model only on a prospective basis, or if the retrospective application of the VIE model is not material, the registration statement may incorporate by reference the registrant’s most recent Form 10-K, which would include its historical annual financial statements of periods prior to the adoption of the VIE model (assuming that the prior financial statements do not require revision for other purposes).

**Applying the Transition Provisions of the VIE Model as amended by ASU 2009-17**

The SEC staff indicated that it expects there to be consistency between the application of the VIE model in the financial statements and in the table of selected financial data. For example, a calendar year-end reporting entity adopts the VIE model on January 1, 2010, and elects to retrospectively apply the VIE model to fiscal years 2009 and 2008. The reporting entity records a cumulative effect adjustment to retained earnings as of January 1, 2008. In this example, if the registrant retrospectively applies the VIE model only to fiscal year 2009, it should apply the VIE model beginning in 2009 in the table of selected financial data. If the registrant elects to retrospectively apply the VIE model to fiscal years 2009 and 2008, the SEC staff indicated that the registrant may decide whether it will also apply the VIE model to fiscal years 2006 and 2007 within the selected financial data table. In all cases, the SEC staff expects a registrant to disclose to which periods it has retrospectively applied the VIE model and, if necessary, the fact that certain periods are not comparable to the periods for which the audited financial statements are provided.
Pro Forma Requirements

The SEC staff indicated that the initial adoption of the VIE model as amended by ASU 2009-17 would not trigger either an Article 11 or an Item 2.01 Form 8-K reporting requirement.

Rule 3-05, Rule 3-14 and Form 8-K Considerations

The SEC staff stated that consolidation upon the initial adoption of the VIE model as amended by ASU 2009-17 would not trigger a Rule 3-05, Item 9.01(a) or Rule 3-14 reporting requirement.

8.2 Effective date

The VIE model as amended by ASU 2009-17 is effective as of the beginning of a reporting entity’s first fiscal year beginning after November 15, 2009, and for the interim periods within that first period, with earlier adoption prohibited. It must be applied to all entities previously subject to the VIE model including those entities that previously met the requirements to be QSPEs that exist on the date of adoption. See VE 2.3 for the deferral of the VIE model as amended by ASU 2009-17 for certain investment entities.

8.3 Questions and interpretive responses

Question 8-1

Can a reporting entity choose a different transition for each VIE that it is required to consolidate under the VIE model as amended by ASU 2009-17?

PwC response

On adoption, the VIE model as amended by ASU 2009-17, may be applied (1) retrospectively with a cumulative effect adjustment to retained earnings as of the beginning of the first year presented or (2) applied as of the date of adoption with a cumulative effect adjustment to retained earnings recognized on that date. This election applies to all instances in which a reporting entity had a variable interest in an entity. Said differently, a reporting entity cannot choose to apply the guidance retrospectively for some entities and not for others. However, as discussed earlier, the measurement method to be used at transition is subject to fair value and unpaid principal balance practicality exceptions. We believe a reporting entity can have a different measurement method for each VIE that it is required to consolidate under the VIE model as amended by ASU 2009-17. Consequently, a reporting entity may have certain VIE assets and liabilities initially consolidated at (i) carrying amounts, (ii) fair value, or (iii) unpaid principal balance. However, if a reporting entity utilizes the fair value or unpaid principal balance practicability exception for any entity, then the reporting entity cannot apply the VIE model as amended by ASU 2009-17 on a retrospective basis. A reporting entity is required to describe the transition method(s) applied and disclose the amount and classification of the consolidated assets or liabilities in its balance sheet impacted by the transition method(s) applied.
**Question 8-2**

If a reporting entity held a variable interest in a VIE that was not consolidated and such variable interest was sold prior to the adoption of the VIE model as amended by ASU 2009-17, does that VIE need to be revaluated at adoption of the VIE model as amended by ASU 2009-17?

**PwC response**

It depends on the transition method elected by the reporting entity. If the VIE model as amended by ASU 2009-17 is applied as of the date of adoption with a cumulative effect adjustment to retained earnings recognized on that date (January 1, 2010, for a calendar year-end company), then the reporting entity does not need to re-evaluate the entity under the VIE model as amended by ASU 2009-17 at the adoption date.

If the VIE model as amended by ASU 2009-17 is retrospectively applied with a cumulative effect adjustment to retained earnings as of the beginning of the earliest year presented, then the reporting entity will need to re-evaluate the entity under the VIE model as amended by ASU 2009-17. If the entity is a VIE and the reporting entity is the primary beneficiary for any of the periods presented, then the reporting entity will have to reflect the consolidation of the VIE for those periods up until its sale.

**Question 8-3**

If a reporting entity elects the unpaid principal balance transition method, would it be required to continue to record the consolidation of securitized structures on a go-forward basis using unpaid principal balance?

**PwC response**

No, the unpaid principal balance practicability exception applies only to day one accounting on the date of adoption of the VIE model as amended by ASU 2009-17. An allowance for credit losses, accrued interest, or other-than-temporary impairment may also need to be recorded on the date of adoption. In periods after the adoption date, such assets and liabilities should be accounted for in accordance with other GAAP, as appropriate. The same holds true where the fair value practicability exception is applied, though in contrast to the unpaid principal balance option, electing the fair value option would require those assets and liabilities to continue to be measured at fair value in subsequent periods with changes in fair value recognized in earnings.
Appendix A: FASB examples of applying the “By Design” model

Reprint of a portion of ASC 810, Consolidation, specifically ASC 810-10-55-55 through 55-86.

ASC 810-10-55-55 through 55-86 includes eight examples to facilitate the understanding of the “by design” model in determining an entity’s variability as well as identifying an entity’s variable interests. We have included a full reprint of ASC 810-10-55-55 through 55-86 below.

Excerpt from ASC 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:

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

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

a. Step 1: Analyze the nature of the risks in the VIE.

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

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

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

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

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

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

b. Interest rate risk associated with interim changes in the fair value of the fixed-rate periodic interest payments received on the fixed-rate investment portfolio
c. Interest rate risk associated with changes in cash received upon the sale of fixed-rate investments prior to maturity.

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

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

b. 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 risks in (a) and (c) in the preceding paragraph to the debt and equity investors, who are the VIE’s variable interest holders.

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

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

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 prior to 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 risks (a), (b), (e), and (f) in the preceding paragraph to the debt and equity investors, which are the VIE's variable interest holders. The interest rate swap is considered a creator of the VIE's variability based on the design of the VIE and the guidance in paragraphs 810-10-25-35 through 25-36.

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

55-65: A VIE is created and financed with $96 of 5-year fixed-rate debt and $4 of equity from investors. The VIE uses the proceeds to purchase $100 of B- and BB-rated fixed-rate securities denominated in Japanese Yen (JPY) with contractual maturities of 5 years. In addition, the VIE enters into a $100 notional 5-year pay-fixed JPY and receive-fixed U.S. dollars (USD) cross-currency swap with a bank. The swap economically converts the fixed-rate JPY-denominated investments to fixed-rate USD investments, effectively offsetting the foreign exchange risk from both periodic interest payments and the amount due upon maturity for the JPY-denominated investments. At the end of five years, all the investments will mature and a final settlement will be paid or received by the VIE on the swap, with the net proceeds used, first, to pay the fixed-rate debt holders and, second, to pay the equity holders to the extent proceeds remain. The transaction was marketed to debt investors as an investment in a portfolio of below-investment-grade, JPY fixed-rate investments (with a third-party swap designed to offset the JPY exchange risk associated with interest and principal repayment on the investments) and credit support from the equity tranche. The equity tranche was negotiated to absorb the first dollar risk of loss. The following diagram illustrates this situation.
55-66: The VIE is exposed to the following risks:

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

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

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

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

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

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

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

b. The VIE was created to provide an investment vehicle for debt and equity investors to be exposed to the credit risk of entities whose securities are denominated in JPY.
c. The swap counterparty is senior to the debt and equity investors, and the debt and equity investors are also exposed to the credit risk from possible default by the swap counterparty to the extent the swap is an asset to the VIE.

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

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

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

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

55-68: A VIE is created and financed with $90 of 3-year floating-rate debt and $10 of equity from investors. The VIE uses the proceeds to purchase $100 of AAA-rated fixed-rate securities, which mature in 3 years. The fixed periodic interest payments received on the investments are used to pay the floating-rate interest to the debt holders with the remainder used to provide a return to the equity investor. At the end of three years, all the investments will mature with proceeds used, first, to pay the floating-rate debt holders and, second, to pay the equity holder to the extent proceeds remain. The VIE is not actively managed. The transaction was marketed to potential debt investors as an investment in a portfolio of high-quality fixed-rate investments with the equity tranche negotiated to provide support in the event of a credit default on the investments or in the event the fixed-rate return on the investments is not sufficient to pay the floating-rate coupon on the debt. The equity tranche was negotiated to absorb the first dollar risk of loss. The following diagram illustrates this situation.
55-69. The VIE is exposed to the following risks:

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

b. Interest rate risk associated with changes in the fair value of the fixed-rate periodic interest payments received on the fixed-rate investment portfolio.

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

a. The VIE was marketed to debt investors as an entity that will be exposed to changes in the fair value of periodic interest payments received on the investments due to changes in interest rates and credit risk associated with the investment portfolio, with the equity tranche negotiated to absorb the first dollar risk of loss. It has been determined that substantive subordination is present with respect to these risks.

b. The equity investor has implicitly issued a $90 notional interest rate swap to the VIE in which that investor agrees to pay the VIE a floating rate and receive a fixed rate. However, the maximum amount “payable” to the VIE is limited to the equity investment. The debt holders will absorb the remaining variability caused by changes in interest rates.

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

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

Based on this analysis, it can be determined that the VIE was designed to create and pass along risks (a) and (b) in the preceding paragraphs 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 the above analysis, it can be determined that the VIE was designed to create and pass along risks (a), (b), and (c) in the preceding paragraph to the note holders, who 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 risks (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 an 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 respect to the obligation of the lessee to the VIE. The following diagram illustrates this situation.

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

a. Price risk with respect to changes in fair value of the underlying 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.

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

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

g. The role of the residual value guarantee and fixed-price purchase option in the design of the VIE, regardless of their legal form or accounting classification, dictates whether those interests should 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 risk (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 risk in (b) in the preceding paragraph to the note and equity holders, all of whom are the VIE’s variable interest holders.

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

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

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

55-83. The following factors should be considered in the determination of the purpose(s) for which the VIE was created and in the determination of the variability the VIE is designed to create and pass along to its interest holders:
a. The VIE was designed to hold offsetting positions with respect to electricity price risk through a forward purchase contract and a forward sales contract with terms that are the same (except for fixed settlement price).

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

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

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

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

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

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

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

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

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

55-85. In these circumstances, because they meet the characteristics described in paragraph 810-10-25-35(a) through (b) and based on the further analysis of the design of the VIE, the two forward contracts are creators of the VIE’s variability. Based on this analysis, it can be determined that the VIE was designed to create and pass along the risks in paragraph 810-10-55-82(a) through (c) to the debt investors, which are the VIE’s variable interest holders.
55-86. If, instead of executing the transaction described in this Case, the electricity producer sold the fixed-price forward sales contract for $100 to an entity that physically owned a power plant and produced electricity, an analysis of the design of that entity would be required, which would involve developing a complete understanding of the purpose for which that entity was created. In this case, the electricity producer also has no further involvement with the entity after receiving its $100. Provided the fixed-priced forward contract to sell is senior in priority to other interest holders, that contract would be strongly indicated as a creator of variability because its underlying is based on observable market rates. In addition, changes in the cash flows or fair value of the fixed-price forward contract typically would not be expected to offset all, or essentially all, of the risk or return (or both) related to the power plant because the risk or return (or both) of the power plant would be affected by factors other than changes in electricity prices (for example, operating costs).
Appendix B: Detailed steps to navigate through the VIE model under ASC 810
Step 1
Determine if the VIE model applies to the reporting entity.

**Step 1A: Is the counterparty a “legal entity?” (VE 2.1)**
- Yes – Proceed to Step 1B.
- No – Apply other appropriate GAAP.

**Step 1B: Does the reporting entity have a variable interest in the entity? (VE 2.2)**
- Yes – Proceed to Step 1C.
- No – Apply other appropriate GAAP.

**Step 1C: Is a scope exception available? (VE 3)**
- Yes – Apply other appropriate GAAP.
- No – Proceed to Step 2.
Step 2
Determine if the entity is a VIE.

Step 2A: Consider the appropriate determination date and the equity investment at risk. (VE 4.1)

Step 2B: Determine if the equity investment at risk has any of the five characteristics of a VIE. (VE 4.2)

Characteristic 1: Is the equity investment at risk insufficient to finance the activities of the entity? (VE 4.2.1)

Characteristic 2: Do the holders of the equity investment at risk lack power to direct activities that most significantly impact the entity’s performance? (VE 4.2.2)

Characteristic 3: Was the equity investment at risk of the entity established with non-substantive voting rights? (VE 4.2.3)

Characteristic 4: Do parties other than the holders of the equity investment at risk have the obligation to absorb expected losses? (VE 4.2.4)

Characteristic 5: Do parties other than the holders of the equity investment at risk have the right to receive the residual returns? (VE 4.2.5)

If the answer to all of the above questions is “no,” the entity is not a VIE. Apply other appropriate GAAP.

If the answer to any of the questions is “yes,” proceed to Step 3 to identify the primary beneficiary.

See Step 5: Determine if a reconsideration event has occurred which could change the status of a VIE (VE 4.3) (see details below); also, consider disclosure requirements. (VE 7)
Step 3
Determine which reporting entity is the primary beneficiary (i.e., which reporting entity should consolidate the VIE).

Step 3A: Identify all other reporting entities that hold variable interests in the VIE. (VE 1 and VE 5.1)

Step 3A1: Identify activities of the VIE that most significantly impact the VIE’s economic performance. (VE 5.1)

Step 3B: Identify all variable interests that are held by related parties and de facto agents. (VE 1 and VE 5.1)

Step 3C: Determine if the reporting entity fulfills both of the following criteria required to be a primary beneficiary. (VE 5.1)

Power Criterion: Does the reporting entity on its own (and if not on its own, its related parties and de facto agents group) have the power to direct the activities of the VIE that most significantly impact the VIE’s economic performance?

If the answer to the above question is “no,” the reporting entity is not the primary beneficiary. Proceed to Step 4C.

If the answer to the above question is “yes,” proceed to the question below.

Losses/Benefits Criterion: Does the reporting entity (and if not on its own, its related parties and de facto agents group) have the obligation to absorb losses of the entity 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?

If the answer to the above question is “yes” and no member of the related parties and de facto agents group on its own should consolidate, proceed to Step 3D.

If the answer to the above question is "yes" and a member of the related parties and de facto agents group on its own should consolidate, proceed to Step 4A.

If the answer to the above question is “no,” the reporting enterprise is not the primary beneficiary. Proceed to Step 4C.

Step 3D: Determine which member of the related party group should consolidate the VIE.

Question: Is the reporting entity most closely associated with the VIE? (VE 5.1.4)

If the answer to the above question is “yes,” the reporting entity is the primary beneficiary; proceed to Step 4A.

If the answer to the above question is “no,” the reporting entity is not the primary beneficiary; proceed to Step 4C.

Reassess the primary beneficiary determination on an ongoing basis (VE 5); also, consider disclosure requirements. (VE 7)
Step 4
Consolidate and/or disclose the VIE.

Step 4A: Determine the initial measurement and accounting for the consolidation of the entity.

Question: Is the reporting entity initially adopting FAS 167?

If the answer to the above question is “yes,” apply the transition guidance (VE 8.1).

If the answer to the above question is “no,” apply the initial measurement and consolidation requirements (VE 6.1).

Step 4B: Perform accounting after the initial measurement. (VE 6.2)

Step 4C: Prepare appropriate disclosures. (VE 7)

Note that the VIE model introduces four key disclosure principles that apply to both the primary beneficiary of a VIE as well as to any reporting entity involved with a VIE, even if such reporting entity is not the primary beneficiary.
Step 5
Determine if a reconsideration event has occurred which could change the status of a VIE.

**Question 1:** Have the entity’s governing documents or contractual arrangements changed in a manner that changes either (1) the characteristics or (2) the adequacy of the entity’s equity investment at risk? (VE 4.3)

If the answer to the above question is “yes,” a reconsideration event has occurred. If the event is significant; proceed to Step 2 to determine if the VIE status has changed.

If the answer to the above question is “no,” proceed to Question 2 below.

**Question 2:** Has (a) any part of the equity investment been returned to the equity investors and (b) other interests become exposed to expected losses of the entity? (VE 4.3)

If the answer to the above question is “yes,” a reconsideration event has occurred. If the event is significant; proceed to Step 2 to determine if the VIE status has changed.

If the answer to the above question is “no,” proceed to Question 3 below.

**Question 3:** Has the entity undertaken additional activities or acquired additional assets, beyond those that were anticipated at the latter of (a) the inception of the entity or (b) the latest reconsideration event, that increase the entity’s expected losses? (VE 4.3)

If the answer to the above question is “yes,” a reconsideration event has occurred. If the event is significant; proceed to Step 2 to determine if the VIE status has changed.

If the answer to the above question is “no,” proceed to Question 4 below.

**Question 4:** Has the entity received an additional equity investment that is at risk or has the entity curtailed or modified its activities in a way that decreases its expected losses? (VE 4.3)

If the answer to the above question is “yes,” a reconsideration event has occurred. If the event is significant; proceed to Step 2 to determine if the VIE status has changed.

If the answer to the above question is “no,” proceed to Question 5 below.

**Question 5:** Have there been changes in facts and circumstances such that the holders of the equity investment at risk, as a group, lose the power from voting rights or similar rights to direct the activities that most significantly impact the economic performance of the VIE?

If the answer to the above question is “yes,” a reconsideration event has occurred. If the event is significant; proceed to Step 2 to determine if the VIE status has changed.

If the answer to the above question is “no,” a reconsideration event has not occurred. The entity remains at its current status (i.e., voting interest entity or VIE).
## Appendix C: Technical references and abbreviations

The following table should be used as a reference for the abbreviations utilized throughout the guide:

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<td>FASB Staff Position SOP 07-1, Effective Date of AICPA Statement of Position 07-1</td>
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<tr>
<td>SAB 103</td>
<td>SEC Staff Accounting Bulletin No. 103, Update of Codification of Staff Accounting Bulletins</td>
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<td>SOP 07-1 (ASC 946-10)</td>
<td>Statement of Position 07-1, Clarification of the Scope of the Audit and Accounting Guide Audits of Investment Companies and Accounting Parent Companies and Equity Method Investors for Investments in Investment Companies</td>
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<td>AcSEC</td>
<td>Accounting Standards Executive Committee</td>
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<td>BCG</td>
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<td>DIG</td>
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<td>QSPE</td>
<td>Qualifying Special Purpose Entity</td>
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<td>VE</td>
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Appendix D: Summary of significant changes

This PwC guide, Variable interest entities – 2013, has been updated. This appendix includes a summary of the noteworthy revisions included in the 2013 edition of this guide and revisions to the presentation and disclosure requirements covered in this guide completed in June 2015.

Revisions to the 2013 edition of the guide completed in June 2015

Chapter 7: Presentation and disclosure requirements

- Guidance was moved to FSP 18

Revisions to the 2012 edition of the guide

Executive Summary

- On the Horizon—The FASB/IASB Joint Consolidation Project was updated to reflect the expected date for the issuance of the final standard on consolidation to the second half of 2013.

Chapter 2: Scope and Scope Exceptions

- Executive Takeaway was updated to reflect the expected date for the issuance of the final standard on consolidation to the second half of 2013.

Chapter 5: Identifying the Prime Beneficiary of a VIE

- Section 5.1.1 was updated with language from the FASB Codification to clarify how to consider situations where economics are heavily weighted to one party and the impact that situation has on the power analysis.

Chapter 6: Initial Consolidation and Subsequent Accounting

- Section 6.2.2 was updated to include an example on the elimination of intercompany interest in a voting interest model.

Appendix B: Detailed Steps to Navigate through the VIE Model under ASC 810

- Step One was reorganized to provide additional clarity into how to determine if the VIE model applies to a reporting entity.
How PwC can help

The VIE Model as amended by ASU 2009-17 represents a consolidation model that is applicable to a wide array of entities. It is a principles-based standard that bases consolidation of a variable interest entity on whether a party has both (i) the power to direct activities that significantly impact the economic performance of the entity and (ii) the exposure to losses or rights to receive benefits that could be potentially significant to the entity.

Our consolidation consultants and Assurance professionals frequently advise companies regarding the interpretation and application of the accounting rules under the VIE Model as amended by ASU 2009-17 and related matters, including:

- Determining whether an interest represents a variable interest;
- Determining whether an entity is a variable interest entity;
- Identifying the primary beneficiary;
- Initial consolidation and subsequent accounting; and
- Identifying appropriate disclosure items.

Our professionals bring value to businesses by understanding and resolving their complex business issues. There will be many such issues related to the implementation of the VIE Model as amended by ASU 2009-17.

If you have any questions or comments, please contact your PwC partner. In addition, the following subject matter experts are available to discuss this subject:

<table>
<thead>
<tr>
<th>David Lukach</th>
<th>Matt Sabatini</th>
<th>Pamela Yanakopulos</th>
</tr>
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<tbody>
<tr>
<td>Financial Instruments, Structured Products, and Real Estate (FSR) Partner</td>
<td>Capital Markets and Accounting Advisory Services (CMAAS) Partner</td>
<td>Capital Markets and Accounting Advisory Services (CMAAS) Partner</td>
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<tr>
<td>646.471.3150</td>
<td>646.471.7450</td>
<td>312.298.3798</td>
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