BDO KNOWS:

VARIABLE INTEREST ENTITIES

A Practice Aid From BDO's National Assurance Practice

August 2010

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EXECUTIVE SUMMARY

THIS VARIABLE INTEREST ENTITY PRACTICE AID IS INTENDED TO FACILITATE THE FOLLOWING DECISIONS:

- Is an entity in the scope of the variable interest entity consolidation model in ASC 810-10?[1]
- Does the reporting enterprise (RE) hold a variable interest (VI) in an entity?
- Is an entity a variable interest entity (VIE)?
- How is the primary beneficiary (PB), if any, of a VIE identified?
- How should the RE initially adopt the revised VIE consolidation guidance?
- How should the accounts of a VIE be consolidated and presented in the consolidated financial statements of the PB?
- When should the status of an entity as a VIE be reconsidered?
- When should the identity of the PB be reconsidered?

The variable interest entity consolidation guidance was issued to address entities for which the voting interest model in ASC 810-10[2] is not appropriate. This situation arises when a controlling financial interest is achieved through arrangements that do not involve voting interests.

The amendments to ASC 810-10 introduced by ASU 2009-17[3] are effective as of the beginning of a reporting enterprise's first annual reporting period that begins after November 15, 2009 and interim periods within that annual period.

Users of this practice aid are encouraged to follow the steps outlined in the flowchart to apply the VIE consolidation criteria required by US GAAP during their initial assessment of an entity or during any subsequent reconsideration. Note that the discussion in Section II, which follows the flowchart, clarifies only some aspects of the steps presented in the flowchart. In that regard, the flowchart is not a substitute for US GAAP and users should ensure any conclusions reached are consistent with the FASB's Accounting Standards Codification.

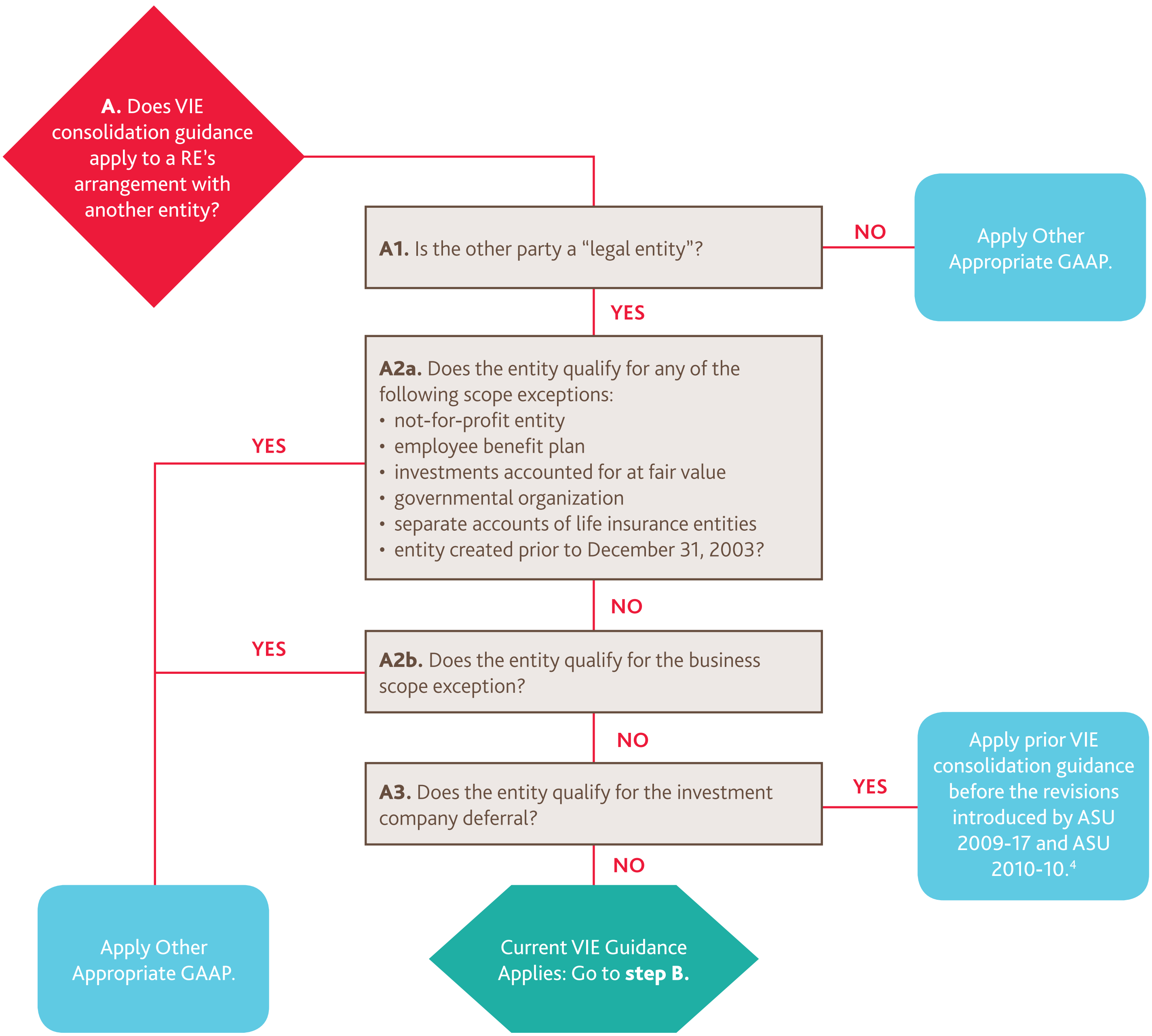
This practice aid has been updated through August, 2010.

1 The variable interest entity guidance in ASC 810-10 *Consolidation* was formerly contained primarily in FASB Interpretation 46R *Consolidation of Variable Interest Entities* (FIN 46R), as amended by SFAS 167 *Amendments to Interpretation No. 46R* (FAS 167).

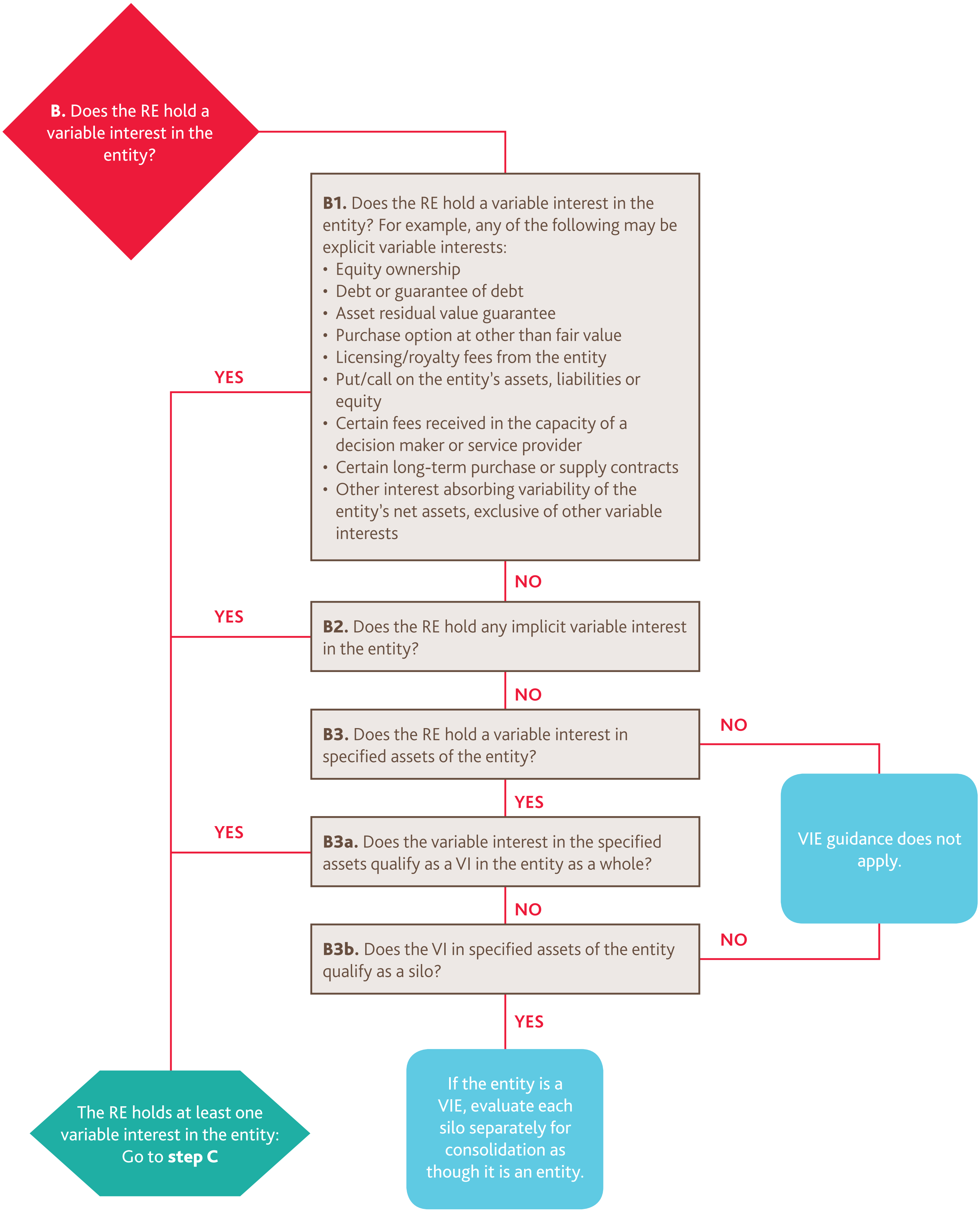
2 ASC 810-10 *Consolidation – General* (formerly ARB 51 *Consolidated Financial Statements*)

3 Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities

I. VARIABLE INTEREST ENTITY CONSOLIDATION FLOWCHART



4 Consolidation (Topic 810): Amendments for Certain Investment Funds.


B. Does the RE hold a variable interest in the entity?
B1. Does the RE hold a variable interest in the entity? For example, any of the following may be explicit variable interests:
• Equity ownership
• Debt or guarantee of debt
• Asset residual value guarantee
• Purchase option at other than fair value
• Licensing/royalty fees from the entity
• Put/call on the entity's assets, liabilities or equity
• Certain fees received in the capacity of a decision maker or service provider
• Certain long-term purchase or supply contracts
• Other interest absorbing variability of the entity's net assets, exclusive of other variable interests
YES
NO
B2. Does the RE hold any implicit variable interest in the entity?
YES
NO
B3. Does the RE hold a variable interest in specified assets of the entity?
NO
VIE guidance does not apply.
YES
B3a. Does the variable interest in the specified assets qualify as a VI in the entity as a whole?
YES
NO
B3b. Does the VI in specified assets of the entity qualify as a silo?
NO
YES
If the entity is a VIE, evaluate each silo separately for consolidation as though it is an entity.
The RE holds at least one variable interest in the entity: Go to step C

C. Is the entity a variable interest entity?

C1. Is the entity's total equity at risk not sufficient to permit the entity to finance its activities without additional subordinated financial support?

YES

NO

C2. As a group, do the holders of the equity at risk lack any of the following three characteristics:

a. Power to direct the activities of the entity that most significantly impact its economic performance (also see note below)

b. Obligation to absorb the expected losses of the entity

c. Right to receive the expected residual returns of the entity?

C2a-Note

The equity investors as a group are also considered to lack the power, through voting interests or similar rights, to direct the activities of the entity that most significantly impact its economic performance if both of the following are present:

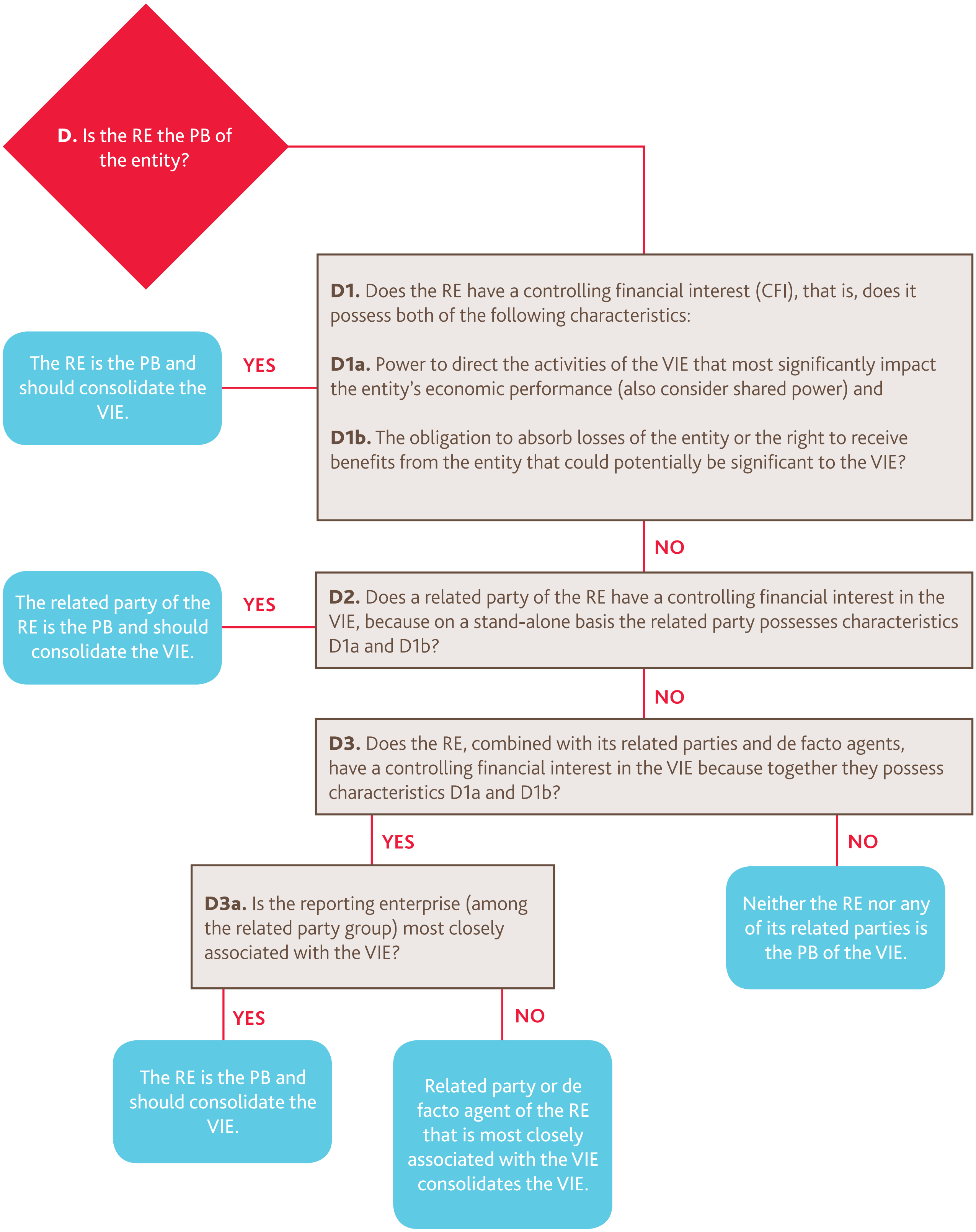
1. Voting rights of some equity investors are not proportional to their obligations to absorb the expected losses of the entity, their right to receive the expected residual returns, or both
2. Substantially all of the entity's activities either involve or are conducted on behalf of an investor that has disproportionately few voting rights.

YES

NO

Entity is a VIE: **Go to step D.**

Entity is not a VIE. Apply other appropriate GAAP.


D. Is the RE the PB of the entity?
D1. Does the RE have a controlling financial interest (CFI), that is, does it possess both of the following characteristics:
D1a. Power to direct the activities of the VIE that most significantly impact the entity's economic performance (also consider shared power) and
D1b. The obligation to absorb losses of the entity or the right to receive benefits from the entity that could potentially be significant to the VIE?
YES
The RE is the PB and should consolidate the VIE.
NO
D2. Does a related party of the RE have a controlling financial interest in the VIE, because on a stand-alone basis the related party possesses characteristics D1a and D1b?
YES
The related party of the RE is the PB and should consolidate the VIE.
NO
D3. Does the RE, combined with its related parties and de facto agents, have a controlling financial interest in the VIE because together they possess characteristics D1a and D1b?
YES
D3a. Is the reporting enterprise (among the related party group) most closely associated with the VIE?
NO
Neither the RE nor any of its related parties is the PB of the VIE.
YES
The RE is the PB and should consolidate the VIE.
NO
Related party or de facto agent of the RE that is most closely associated with the VIE consolidates the VIE.

II. DISCUSSION OF VIE CONSOLIDATION FLOWCHART

▶A. DOES VIE CONSOLIDATION GUIDANCE APPLY?

A1. WHAT QUALIFIES AS A "LEGAL ENTITY"?

The term "legal entity" refers to any legal structure that is used to conduct activities or to hold assets. Examples of such structures include corporations, partnerships, limited-liability companies, trusts, research and development ventures, and majority owned subsidiaries.[5] This practice aid uses the terms "legal entity" and "entity" interchangeably.

A2B. BUSINESS SCOPE EXCEPTION

The VIE guidance provides an exclusion for several entities. The scope exception in paragraph ASC 810-10-15-17d addresses an entity that is deemed to be a "business." In order to qualify for the business scope exception, an entity must satisfy the following two-step requirement.

First, the entity must meet the definition of a business: an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants.[6]

Second, the reporting enterprise must evaluate the entity and its relationship with the entity under paragraph ASC 810-10-15-17d. If any of the following four conditions exist, the entity does not qualify for the business scope exception:

- The reporting enterprise, its related parties, or both, participated significantly in the design or re-design of the entity. However, this condition does not apply if the entity is an operating joint venture[7] or a franchisee.[8]
- The entity is designed so that substantially all of its activities either involve or are conducted on behalf of the reporting enterprise.
- The reporting enterprise or its related parties provide more than half of the total of equity, subordinated debt, or other forms of subordinated financial support.
- The activities of the entity are primarily related to securitizations or other forms of asset-based financings or single-lessee leasing arrangements.

Judgment is required to determine whether "substantially all" of the entity's activities either involve or are conducted on behalf of the reporting enterprise. Generally, the factors considered at step A2b should be consistent with those at step **C2a-note 2** (determining whether entity is a VIE). Suggested factors to consider are listed below in section **C2a-note 2**.

A3. INVESTMENT COMPANY DEFERRAL

As outlined in ASU 2010-10, the FASB deferred the revisions to the variable interest consolidation model introduced by ASU 2009-17 for interests in entities that qualify as investment companies under ASC 946-10-15-2 and that meet certain other conditions. Interests in mutual funds, hedge funds, venture capital and private equity funds are examples that may meet the conditions for deferral, whereas interests in securitization entities, asset-backed financing entities, entities formerly classified as qualifying special purpose entities (QSPEs) and collateralized debt obligation structures (CDOs) would not. While an entity may initially qualify for the deferral, an ongoing assessment is required because the entity may cease qualifying at a later date due to new facts and circumstances.

If an entity qualifies for one of the scope exceptions in section A1, A2 or A3, users should apply other appropriate GAAP (which is beyond the scope of this practice aid), such as the voting interest consolidation model, the proportionate consolidation model, investment company accounting guidance, the equity method of accounting, investments in debt and equity securities, etc.

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5 ASC Master Glossary

6 Ibid.

7 A corporation owned and operated by a small group of entities as a separate and specific business or project for the mutual benefit of the members of the group. The purpose of a corporate joint venture frequently is to share risks and rewards in developing a new market, product or technology; to combine complementary technological knowledge; or to pool resources in developing production or other facilities. A corporate joint venture also usually provides an arrangement under which each joint venturer may participate, directly or indirectly, in the overall management of the joint venture. Joint venturers thus have an interest or relationship other than as passive investors. An entity that is a subsidiary of one of the joint venturers is not a corporate joint venture. The ownership of a corporate joint venture seldom changes, and its stock is usually not traded publicly. A noncontrolling interest held by public ownership, however, does not preclude a corporation from being a corporate joint venture. (ASC Master Glossary)

8 The party who has been granted business rights to operate the franchised business. (ASC Master Glossary)

▶B. DOES THE REPORTING ENTERPRISE HOLD A VARIABLE INTEREST IN THE ENTITY?

A variable interest is a contractual, ownership, or other monetary interest in the entity whose value changes with changes in the fair value of the entity's net assets, exclusive of variable interests.

Assets and operations of an entity typically *create* variability and, thus, are not variable interests, whereas liabilities and equity interests typically *absorb* variability, and thus, are variable interests. Other contracts or arrangements, such as derivatives, 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, dictates whether that interest should be treated as creating variability for the entity or absorbing variability.[9]

ASC 810-10-25-22 outlines the process the reporting enterprise should apply to identify variable interests in the entity:

> The variability to be considered in applying the Variable Interest Entities Subsections shall be based on an analysis of the design of the legal entity as outlined in the following steps:
> - Step 1: Analyze the nature of the risks in the legal entity (see paragraphs 810-10-25-24 through 25-25)
> - Step 2: Determine the purpose(s) for which the legal entity was created and determine the variability (created by the risks identified in Step 1) the legal entity is designed to create and pass along to its interest holders (see paragraphs 810-10-25-26 through 25-36).

B1. POTENTIAL VARIABLE INTERESTS

There are many types of variable interests. For example:
- Equity interests
- Beneficial interests
- Debt interests
- Guarantees (for instance, on the residual value of leased property or debt of the entity, in which the guarantor is exposed to negative variability in the entity's assets or liabilities)
- Certain purchase options at other than fair value (commonly held by a lessee, they provide the lessee with the right to receive positive variance in the fair value of leased property by purchasing the property at a fixed price below the future fair value of the property).
- Licensing or royalty arrangements
- Put and call options to sell or purchase assets, liabilities or equity of the entity
- Management or service contracts
- Certain franchise arrangements
- Co-marketing arrangements
- Forward contracts to sell assets
- Certain long-term supply contracts at a fixed price per product or unit of service
- Certain long-term purchase contracts for fixed quantities of product or units of service
- Certain research and development funding arrangements

Selected examples of variable interests in different scenarios follow.

9 ASC 810-10-25-26

Example 1: Variable interests in a leasing entity

Assume that a Leasing Entity is created by its Equity Owner to hold a building and a 30 year mortgage issued to finance the acquisition of the building. The Leasing Entity is considered thinly capitalized since its equity was insufficient to obtain the loan without the support of the Equity Owner's guarantee (see section C1 below).

The same Equity Owner is also the majority and controlling shareholder of an Operating Company that enters into a leasing agreement with the Leasing Entity to use the building for its office space needs for the first ten years of the mortgage term. The Operating Company's monthly lease payments are sufficient to cover the monthly mortgage payment of the Leasing Entity. Concurrent with entering into the lease agreement, the Operating Company obtains the right to purchase the building at the end of the ten-year lease term for a fixed price of $4.5 million, which is expected to be less than the expected fair value of the building at that time. In addition, the Operating Company extends a residual value guarantee on the building to the Leasing Entity, whereby, the Operating Company is obligated to purchase the building for a fixed price of $4 million if it does not extend the lease on the same terms or find another party to enter into a similar lease with the Leasing Entity. The $4 million represents the remaining mortgage principal balance at the end of the ten year lease term.

The lease is not a variable interest because it creates variability in the Leasing Entity.

This leasing structure transfers substantially all of the rights and obligations of equity ownership of the Leasing Entity to the Operating Company. The Operating Company has two variable interests in the Leasing Entity:
- The building purchase option, which absorbs the upside appreciation of the building above the $4.5 million fixed option purchase price; and
- The building residual value guarantee, which absorbs the downside risk of the building's value falling below $4 million and the Leasing Company's potential default on the mortgage if it is unable to secure a lessee after the initial ten year lease term.

The Operating Company may also have an implicit variable interest in the Leasing Entity, if past practices or arrangements indicate that the Equity Owner would rely on resources from the Operating Company to fulfill his mortgage guarantee obligation, if the need arises.

Further, the common Equity Owner has the following variable interests in the Leasing Entity:
- Equity interest in the Leasing Entity
- Mortgage guarantee in the Leasing Entity.

License and royalty fees

Examples in other industries include licensing or royalty fee arrangements to exploit the value of a reporting enterprise's trademarks and proprietary technologies. These arrangements are generally linked to the entity's performance indicators (revenue, EBITDA, etc). As such, the licensor (reporting enterprise) is exposed to changes in the fair value of the entity's net assets or economic performance, and hence, holds a variable interest in the licensee entity. For instance, in industries like apparel and electronic equipment, the owner of a trademark or technology can license the right to manufacture and sell products using the proprietary trademark or technology to a licensee entity in exchange for a royalty fee of a stated percentage of the applicable product revenues. In other industries, like biomedical research and development, a pharmaceutical company may extend research and development funding to a biomedical research entity and concurrently enter into a licensing agreement to collect a fee based on of the entity's gross profit margin from all future sales of the subject biomedical product.

Fees paid to decision makers or service providers

Fees paid by the entity to decision makers (e.g., management fees) or service providers may be variable interests in the entity held by the service provider. However, an exception exists under which decision maker and service provider fees do not to constitute a variable interest in the entity, if all six conditions listed in ASC 810-10-55-37 are met (Note: the decision maker or service provider must consider its related parties and de facto agents[10] in the assessment of all six conditions):

10 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.

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 entity that arise in the normal course of the entity'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 entity's expected losses or receive more than an insignificant amount of the entity'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 entity's anticipated economic performance.

The FASB expects that fees paid to an enterprise that acts solely as a fiduciary or agent should typically not represent a variable interest in a VIE[11] as these fees would typically meet all six criteria in paragraph ASC 810-10-55-37.

For purposes of assessing "significance" in evaluating conditions c), e) and f) above, the reporting enterprise may employ the quantitative approach described in the definitions of the terms "expected losses (section **C2b**)," "expected residual returns" (section **C2c**), and expected variability. However, a quantitative test is only part of the assessment and cannot be the sole determinant. That is, ASU 2010-10 indicates a qualitative assessment is always required.

With respect to condition c), equity in the entity held by the decision maker or service provider is generally inconsistent with the fiduciary concept because it represents an obligation to absorb losses and a right to receive benefits. In contrast, fixed fee arrangements, such as a 1% of assets under management, may qualify for the exception depending on the terms.

Moreover, determining whether a decision maker or service provider fee arrangement meets the scope exception described above will require an understanding of similar contracts in the VIE's industry to help ascertain whether it represents a mere fiduciary relationship.

Option to acquire or sell the entity's assets, liabilities or equity
In conjunction with entering into a financing, licensing, distributorship, or supply contract with an entity, a reporting enterprise may also obtain the option to buy or sell assets, liabilities or equity of the entity. These call or put options will often constitute variable interests as they expose the reporting enterprise to positive or negative variability in the underlying net assets of the entity. For example, a reporting enterprise holds an option to purchase common stock of the entity for a fixed price within a pre-defined period or upon the occurrence of a specified condition. The option exposes the reporting enterprise to the positive variability in the entity's net assets (equity) above the option's fixed exercise price and represents a variable interest in the entity.

B2. IMPLICIT VARIABLE INTERESTS

In determining whether a reporting enterprise has a variable interest in an entity, implicit variable interests should also be considered, as discussed in ASC 810-10-25-51 through ASC 810-10-25-54. An implicit variable interest is an unwritten variable interest that exists because of an oral understanding between parties or a pattern of behavior resulting from past transactions. A reporting enterprise can have an implicit variable interest in an entity regardless of whether the entity is a related or unrelated party. Examples of implicit variable interests follow:

- Parents own an operating company (reporting enterprise) and their children own a leasing entity that leases assets to the operating company. There might be an oral understanding that the parents, through the operating entity, will absorb any losses incurred in the leasing entity through adjusting or modifying the future lease payments to cover the losses of the leasing entity.
- A lease does not have a written renewal option, but the operating company (lessee) has renewed the lease repeatedly for rent equal to the leasing entity's debt service. This pattern indicates that the operating company might have an implicit renewal option at a formula tied to the leasing entity's debt service obligation.
- The owner of both an operating company and a leasing entity guarantees the leasing entity's debt, while the operating company does not guarantee the leasing entity's debt. There might be an unwritten (implicit) understanding that the operating company will provide funds to its owner in the event that the guarantee is called upon.

All of the relevant facts and circumstances must be considered when determining whether an implicit variable interest exists. In that regard, it is important to obtain a thorough understanding of the economic incentives or conflicts of interest that exist in a particular situation because they may influence behavior and shed light on the presence of an implicit variable interest.

11 Paragraph A76, Appendix A *Background Information and Basis for Conclusions* of FAS 167

B3. VARIABLE INTEREST IN SPECIFIED ASSETS OF THE ENTITY

A variable interest in specified assets of a variable interest entity is considered a variable interest in the entity only if the fair value of the specified assets is more than half of the total fair value of the entity's assets, or if the reporting enterprise has another variable interest in the entity as a whole (except interests that are insignificant or have little or no variability).[12]

For instance, a reporting enterprise may provide a residual value guarantee in connection with the leasing entity's only property – a warehouse building. Since the warehouse constitutes more than 50% of the leasing entity's total assets, this single variable interest in the warehouse constitutes a variable interest in the leasing entity as a whole.

If an enterprise holds a variable interest in a specified asset of the entity (for instance, a building), and this asset is the only source of payment for specified liabilities of the entity (a mortgage on the building), then the asset and liability group is treated as a silo (a VIE within a VIE) and should be considered for consolidation by the reporting enterprise.

If a reporting enterprise has a variable interest in an entity (or a silo), where the entity (or silo) does not qualify for one of the scope exceptions listed in step A2a and A2b above, the next step is to determine whether the entity (or silo) is a variable interest entity (step C). The sequence of identifying variable interests (step B) and determining whether the entity is a VIE (step C) can be reversed. That is, in some cases it may be more efficient to determine whether an entity is a VIE first, because if it is not, the reporting enterprise is precluded from consolidating it under the variable interest model. Regardless of the order, the analysis should reach the same conclusion.

▶C. IS THE ENTITY A VIE?

ASC 810-10-15-14 outlines two conditions, either of which renders an entity a variable interest entity and places it within the scope of the VIE consolidation guidance. These two conditions are outlined in steps **C1** Equity at risk is not sufficient and **C2** The holders of the equity lack any of the three characteristics of equity investors.

C1. IS AN ENTITY'S TOTAL EQUITY AT RISK NOT SUFFICIENT TO PERMIT THE ENTITY TO FINANCE ITS ACTIVITIES WITHOUT ADDITIONAL SUBORDINATED FINANCIAL SUPPORT?

"Equity at risk" consists of all investments classified as equity on the entity's balance sheet under US GAAP, adjusted to exclude the following:

- Equity investments that do not participate significantly in the entity's profits and losses, regardless of their voting rights
- Equity instruments which the entity issued in exchange for subordinated interests in other VIEs
- Amounts provided to the equity investor directly or indirectly by the legal entity or other parties involved with the legal entity, provided that the investment provider and the investor are not included in the same set of consolidated financial statements
- Amounts financed for the equity investor (e.g., loans or guarantees of loans) directly by the legal entity or another party 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 fair value of the total assets and equity of the entity have to be estimated as of the equity sufficiency determination date, or latest reconsideration event (Section V). ASC 810-10-25-45 through 25-47 discuss the amount of total equity at risk that is necessary to permit an entity to finance its operations without additional subordinated financial support and provide qualitative and quantitative approaches to this assessment.

ASC 810-10-25-45 establishes the following rebuttable presumption: "An equity investment at risk of less than 10 percent of the legal entity's total assets shall not be considered sufficient to permit the legal entity to finance its activities without subordinated financial support in addition to the equity investment unless the equity investment can be demonstrated to be sufficient."

However, paragraph 25-46 indicates that in some industries it may be common for lenders to require the entity to have a higher equity financing percentage in order to extend additional debt financing without subordinated financial support.

The three indicators that may demonstrate the ability to finance the entity's operations without additional subordinated financial support, even if the equity at risk is below 10% of the entity's total assets are:

- The entity has demonstrated (e.g., through past debt financing) that it can finance its activities without additional subordinated financial support.

12 ASC 810-10-25-55

- The 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.
- The amount of equity invested in the entity exceeds the estimate of the entity's expected losses based on reasonable quantitative evidence.

The design of the legal entity, the apparent intentions of the parties that created the legal entity, the ratings of its outstanding debt, the interest rates and other terms of its debt are all important qualitative considerations as to whether the equity at risk is deemed sufficient. For example, non-investment grade subordinated debt and debt guarantees may be qualitative indicators that the equity at risk is insufficient since these instruments may effectively function as a residual interest in the entity, i.e., equity.

C2. DO THE HOLDERS OF THE EQUITY AT RISK, AS A GROUP, LACK THE THREE TYPICAL CHARACTERISTICS OF EQUITY INVESTORS?

The equity investors, as a group, may lack one of the three characteristics typically associated with equity investment holdings (common shares, partnership units, etc). If the rights and obligations provided by the total equity investment at risk lack any of the following three characteristics, then the ownership of a majority of the voting equity investment (i.e. application of the voting interest model) would not provide an appropriate basis for determining which party should consolidate the entity. Accordingly, the VIE consolidation model applies. The three characteristics are:

- The power to direct through voting rights or similar rights the activities of an entity that most significantly impact its economic performance. Other interests held by the equity investors (e.g., power granted through loans, licensing or service arrangements) may not be considered in determining whether those equity holders have the power to direct these activities.[13]
- The obligation to absorb the expected losses[14] of the entity (e.g., the equity holders are not guaranteed a return or protected from losses by other parties).
- The right to receive the expected residual returns[15] of the entity (e.g., return is not capped like in a debt investment).

As shown in the flowchart step **D1b**, the term "economic interest" refers to expected losses and/or residual returns accruing to a reporting enterprise.

A common situation where the equity holders as a group lack the power to direct is when the entity has conferred the control over its most significant activities through a management contract to a party that does not hold equity at risk and the management contract qualifies as a variable interest in the entity.

It is noteworthy that under the previous VIE consolidation guidance, kick-out rights[16] or participating rights[17] held by the equity holders as a group with respect to a manager or service provider, were often deemed to represent ultimate power over the activities that most significantly impact the entity's economic performance. Under the revised VIE consolidation guidance, a single equity holder (including its related parties and de facto agents) must hold the kick-out right in order for the equity holders as a group to have the power to direct the activities of the entity that most significantly impact its economic performance. The FASB made this change to prior guidance because the Board was troubled that in practice, such rights have been considered substantive for accounting purposes but were rarely exercised. Under the revised guidance, if kick-out rights are held by more than one equity holder, these rights are ignored, the equity holders as a group are deemed to lack power, and the entity in question is a VIE.

13 For further guidance on identifying the activities that most significantly impact an entity's economic performance, refer to section D1a below.

14 Expected losses and expected residual returns refer to amounts derived from expected cash flows as described in FASB Concepts Statement 7 *Using Cash Flow Information and Present Value in Accounting Measurements*, which are discounted and otherwise adjusted for market factors and assumptions. A legal entity that has no history of net losses and expects to continue to be profitable in the foreseeable future will generally 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 in the net income or loss. Refer to ASC 810-10-55-42 through 55-54 for examples on computing the expected losses, expected residual returns and expected variability.

15 Ibid.

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

17 Participating rights are the ability to block the actions through which an enterprise exercises the power to direct the activities of a VIE that most significantly impact its economic performance. These rights should not be confused with protective rights (commonly held by creditors or landlords) which 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.

Example 2: Kick-out or participating rights in a limited partnership

To illustrate, many partnerships consist of a single general partner and many limited partners. These partnership agreements commonly assign responsibility for operations to the general partner, while the limited partners are passive. Often, the general partner's equity is not considered "at risk" because he "paid" for it by providing services. However, the limited partners who contributed the "at risk" equity were deemed to retain power of the partnership's operations by virtue of kick-out rights or participating rights under prior guidance. For example, if predefined circumstances occurred, such as significant deterioration in financial condition, the limited partners acting as a group could kick the general partner out. While latent, this ability meant that the equity investment at risk (i.e., the limited partners' capital) represented power over the partnership. Therefore it was not considered a VIE and the variable interest model didn't apply.

Under the revised VIE model, kick-out rights and participating rights are no longer relevant to the analysis, unless a single party has the unilateral ability to exercise them (including its related parties and de facto agents). The FASB acknowledged that the new evaluation of kick-out rights and participating rights under the revised VIE model is different than how they are currently treated in the voting interest model (ASC 810-10-25-2 through 25-14 and ASC 810-20-25), but decided that the inconsistency would be considered in a separate project to reconsider consolidation policy more broadly.

In the partnership illustration above, the limited partners would now be deemed to lack power over the partnership's activities because no single limited partner could remove the general partner, meaning the partnership would be considered a VIE. Further, the general partner would hold a controlling financial interest because it possesses the ability to direct the partnership's most significant activities, as well as an obligation to absorb losses and a right to receive returns. Consequently, the general partner would be the primary beneficiary and consolidate the partnership.

C2a-note: The anti-abuse clause (When the economics are disproportionate to the votes)
The equity investors as a group are also considered to lack the ability to direct the activities that most significantly impact the entity's economic performance if both of the following conditions are present:
- 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.
- Substantially all of the legal entity's activities either involve or are conducted on behalf of an investor that has disproportionately few voting rights.[18]

This provision was designed to prevent a primary beneficiary from avoiding consolidation of a variable interest entity by organizing the entity with non-substantive voting interests. The situation in **C2a-note** is different from the criteria in **C2a** and **C2b** for determining whether the entity is a VIE in that all variable interests held by the equity investors must be considered, not just their equity-at-risk interests.

Judgment should be applied based on the facts and circumstances when determining whether economics and voting rights are disproportionate. Generally, the two amounts only need to be approximately the same to be considered proportional (for instance, 65% voting rights and 70% economic interest). As the level of stated voting power and economic interest grow increasingly disparate, skepticism that voting interests determine power over the activities that most significantly impact the entity's economic performance should increase. The level of an entity's economic interest is generally indicative of the amount of power the reporting enterprise holds.[19] In practice joint ventures and partnerships frequently feature disproportionate voting and economic interests when at least one equity investor has other variable interests in the entity which do not convey voting rights to that equity investor.

If one investor has an economic interest exceeding 50% but less than 50% of the voting rights, this investor's voting and economic interests would generally be considered disproportionate. If the same investor also satisfies criterion **C2a-note2**, whereby substantially all of the activities of the entity involve or are conducted on behalf of that investor, then the entity is a VIE and the investor may also be the primary beneficiary of the VIE.

C2a-note 2: Do substantially all of the entity's activities involve or are they conducted on behalf of an investor?
In this context, the FASB has not prescribed a quantitative threshold to define "substantially all." In practice, companies might consider the following list of indicators (which is not all-inclusive) in determining whether substantially all of the activities of the entity either involve or are conducted on behalf of the reporting enterprise:[20]

18 ASC 810-10-15-14(c)
19 ASC 810-10-25-38G
20 Note, "the equity investor with disproportionately few voting rights" is the same as "the reporting enterprise" in the list of indicators.

- The majority of the entity's products or services are bought from (for purposes of resale to third parties) or sold to the equity investor with disproportionately few voting rights.
- The investor with disproportionately few voting rights has a call option to purchase the variable interest of the other equity investors in the entity.
- The other equity investors in the entity have a put option to sell some/all of their variable interests to the equity investor with disproportionately few voting rights.
- Substantially all of the entity's assets are acquired from the equity investor with disproportionately few voting rights.
- A significant portion of the entity's assets are leased to or from the investor with disproportionately few voting rights.
- Employees of the equity investor with disproportionately few voting rights are actively involved in managing the operations of the entity (e.g., they hold board seats and/or advise the entity's management).
- Employees of the entity receive compensation tied to the stock or operating results of the equity investor with disproportionately few voting rights.
- The entity's operations are substantially similar in nature or complementary to the activities of the equity investor with disproportionately few voting rights.
- The entity's operations are more important to the equity investor with disproportionately few voting rights than the other variable interest holders.
- The equity investor with disproportionately few voting rights participates in many of the substantive decisions regarding the entity's operations and financing.
- The equity investor with disproportionately few voting rights is or feels obligated to fund operating losses of the entity, or the entity is financially dependent on the same equity investor.
- The equity investor is obliged (may be an implicit commitment demonstrated through past practice) to provide a majority of any additional capital contributions that may be necessary to cover the entity's operating shortfalls.
- The investor with disproportionately few voting rights outsources certain of its activities to the entity, or vice versa.
- The entity performs research and development activities and the reporting enterprise is in a business that could capitalize (through a variable interest other than its equity interest in the entity) on the results of the research that constitutes a majority of the entity's activities.

Not all of these conditions need to be present to conclude that the activities of the entity are conducted substantially on behalf of the reporting enterprise with disproportionately few voting rights, but generally the presence of a few of them is a strong indicator that this is the case.

Activities that involve or are conducted on behalf of the related parties of the investor with disproportionately few voting rights shall be treated as if they involve or are conducted on behalf of the investor (for purposes of **C2a-note2**).

Having established that the entity is a VIE, the next step in the process is to determine which reporting enterprise, if any, should consolidate the VIE.

▶D. HOW IS THE PRIMARY BENEFICIARY OF THE VIE, IF ANY, IDENTIFIED?

A reporting enterprise shall consolidate a VIE when the enterprise has a variable interest (or combination of variable interests) that provides the enterprise with a controlling financial interest on the basis of paragraphs ASC 810-10-25-38A through 38G. The enterprise with a controlling financial interest is called the primary beneficiary, and possesses both of the following characteristics:

a) The power to direct the activities of a VIE that most significantly impact the VIE's economic performance ("power")
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 ("economic interest").

The reporting enterprise should first assess whether it has power and an economic interest on a stand-alone basis and if so, conclude that it is the primary beneficiary (step **D1**). If the reporting enterprise is not the primary beneficiary, its related parties (including de facto agents) should individually evaluate whether any of them have power and an economic interest in the VIE, and thus, qualify as the primary beneficiary (step **D2**). If such a conclusion cannot be reached for either the reporting enterprise or any of its related parties on a stand-alone basis, the analysis should be performed on a collective basis for the RE and its related parties. Collectively, if the group has the characteristics of a primary beneficiary, then the party within the group that is "most closely associated" with the VIE must consolidate it (step **D3**).

The assessment under ASC 810-10-25-38A as to which party involved with the VIE has the controlling financial interest, and thus, is the primary beneficiary, is primarily qualitative and 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. Often more than one enterprise could have the economic interest characteristic in **D1b**, but only one enterprise, if any,[21] will have the power to direct the activities of a VIE that most significantly impact its economic performance.

D1A. HOW IS THE POWER TO DIRECT THE ACTIVITIES OF THE VIE THAT MOST SIGNIFICANTLY IMPACT ITS ECONOMIC PERFORMANCE IDENTIFIED?

To assess power, the enterprise must first identify the activities, which most significantly impact the VIE's economic performance. To identify these activities, the reporting enterprise should consider the risks that the VIE is designed to create and pass to its variable interest holders. Some common risks are: operational risk (risk of mismanaging work force, not meeting customer expectations, selecting vendors, not identifying timely improvements to production processes or catching up with competitor innovations, etc), credit risk, interest rate risk, foreign currency exchange risk, commodity price risk, equity price risk, market risk (including the risk that the value of the entity's assets will increase or decrease), etc. Identifying a VIE's risks will often shed light on activities that are put in place to contribute to the VIE's economic performance. Judgment is required to determine which variable interest holder, if any, directs the activities that most significantly impact the entity's economic performance.

Involvement in the design of an entity may indicate that the enterprise had the opportunity and incentive to establish arrangements that result in the enterprise being the party with the power. However, that involvement in isolation does not establish that enterprise as the party with the power. Reporting enterprises must specifically evaluate who holds power by having the right to direct the activities that most significantly impact the entity's economic performance.

A reporting enterprise'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.[22]

In some cases, the reporting enterprise will have rights (by design of voting rights, board representation, by written agreement between the parties, etc.) to direct the activities that most significantly impact the VIE's economic performance, but chooses not to exercise these rights on a regular basis. Infrequent exercise of a right to direct should not be construed as lack of power to direct as described in ASC 810-10-25-38B. Further, the description of activities as "day-to-day management" or "strategic management" do not necessarily mean that these activities are the ones that most significantly impact the economic performance of the VIE.

In determining whether a reporting enterprise has power, the enterprise should consider kick-out rights or participating rights held by a single enterprise (including its related parties and de facto agents[23]). The enterprise that holds the kick-out or participating rights, depending on their nature and significance to the entity's economic performance, could be the party that meets the D1a power criterion and qualifies as the primary beneficiary. Kick-out and participating rights held by more than a single enterprise involved with a VIE do not affect the primary beneficiary analysis under the VIE consolidation model.[24]

Kick-out rights must be substantive to impact the primary beneficiary analysis. In practice companies may consider the guidance in ASC 810-20-25-8 to assess the substance of kick-out rights (the list below is not all inclusive):
- Kick-out rights subject to conditions that make it unlikely they will be exercised, for example, conditions that limit the timing of exercise
- Financial penalties or operational barriers associated with replacing the decision maker or service provider, as these act as disincentive for removal
- The absence of an adequate number of qualified replacement decision makers or service providers or the lack of adequate compensation to attract a qualified replacement
- The absence of an explicit, reasonable mechanism by design or by agreement, by which the holders of the rights can exercise those rights
- The inability of the party holding the kick-out right to obtain the information necessary to exercise such right.

The determination of the primary beneficiary is not affected by protective rights held by the other parties involved with the VIE. Protective rights are designed to protect the interests of the party holding those rights without giving that party a controlling financial interest in the entity. They include, for example:
- Approval or veto rights granted to other parties (e.g., lenders) 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 the entity (e.g., entering a new business or discontinuing an existing a line of business) or apply in exceptional circumstances, for instance:
  - 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

21 See discussion of shared power in section D1a.

22 See ASC 810-10-25-38B. Such contingent power is distinguished from protective rights that are designed to protect the interests of the party holding those rights without giving that party a controlling financial interest in the VIE, as discussed later in this section.

23 ASC 810-10-25-38C

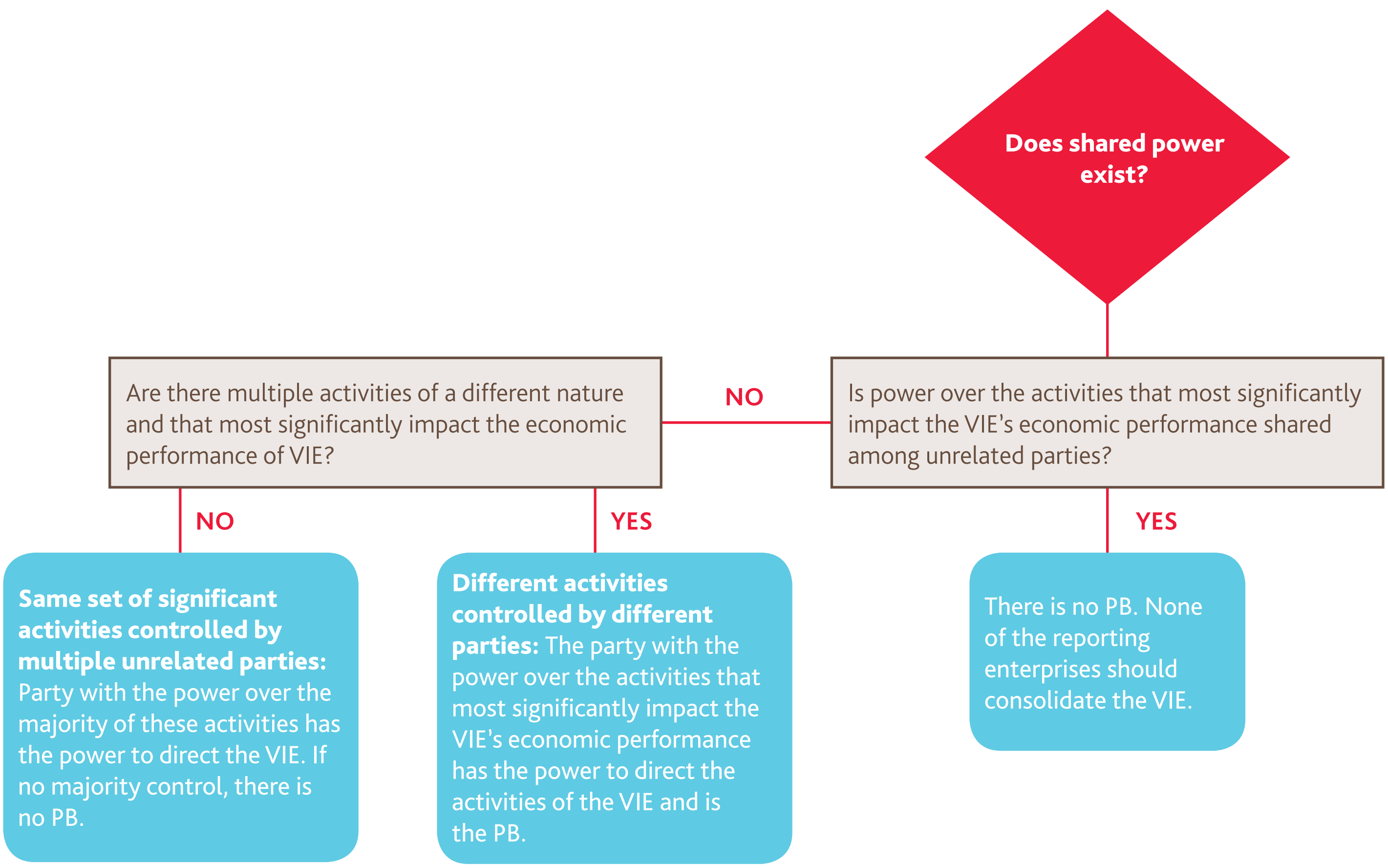
24 However, if the entity is a non-VIE partnership, and hence, is evaluated for consolidation under the voting interest model, kick-out or substantive removal rights held by a group of unrelated parties involved with the entity may prevent the general partner from consolidating the partnership.

  – The right to approve a capital expenditure greater than a particular amount, or the right to approve the issuance of equity or debt instruments.
- The ability to remove the enterprise that has a controlling financial interest in the entity in circumstances such as bankruptcy or a breach of contract by that enterprise
- Limitations on the operating activities of the entity, which are intended to protect the brand name or integrity of the holder; for instance, a franchisor list of limitations or general rules by which the franchisee has to operate the entity is considered a franchisor's protective right.

With respect to the larger question regarding whether a variable interest holder has power over a VIE, the FASB decided guidance was needed when the economics of the holder's interest is inconsistent with its stated power from those interests. Consequently, it indicated that "consideration should be given to situations in which an enterprise's economic interest in a variable interest entity, including its obligation to absorb losses or its right to receive benefits, is disproportionately greater than its stated power to direct the activities of the VIE that most significantly impact the entity's economic performance. Although this factor is not intended to be determinative in identifying a primary beneficiary, the level of a reporting entity's economic interest may be indicative of the amount of power that reporting entity holds."[25]

In other words, the FASB believes that the level of skepticism about a reporting enterprise's lack of stated power should increase as the disparity between an enterprise's economic interest and its power increases. This provision is similar to the disproportionate voting interests criterion for determining whether an entity is a VIE in section **C2a-note** above. The greater a reporting enterprise's exposure to the entity's risks (positive and negative), the more likely the enterprise would be to hold power over the entity.

WHEN IS POWER BETWEEN ENTERPRISES HOLDING VARIABLE INTERESTS IN AN ENTITY CONSIDERED SHARED?



25 ASC 810-10-25-38G

Power is shared if each (not one) of the unrelated parties is required to consent to all decisions relating to the activities that most significantly impact the entity's economic performance. The governance provisions of the entity should be evaluated to ensure that the consent provisions are indeed substantive, by evaluating the remedies or the ramifications in cases where one party acts without the consent of other(s).

If the enterprise determines that power is, in fact, shared among multiple unrelated parties such that no one party has the power to direct the activities of a variable interest entity that most significantly impact its economic performance, then no party is the primary beneficiary and no party consolidates the VIE. By definition, shared power does not exist between related parties holding variable interests in the same VIE. Accordingly, if two related parties have an arrangement to "share" power, one of them will be identified as the primary beneficiary and will have to consolidate the VIE.

If each party is directing the same set of activities and power is not shared, the party controlling the majority (>50%) of the activities (e.g., the same activities carried out in different regions) is the primary beneficiary. For instance, two real estate management companies form a joint venture to manage twenty commercial rental buildings with approximately equal profitability and cash flow profiles. Each real estate manager holds 50% of the voting rights and is responsible for 50% of the entity's mortgage loans in the event of default, and each represents 50% of the board of directors. The first real estate management company manages fifteen of the commercial buildings which are located on the East Coast and the second management company manages the other five buildings, which are located on the West Coast. Power is not shared as each party is not required to consent to the other's decisions with respect to the buildings located in its region. As each party is directing the same activities, the party with the power over the majority of the activities (the East Coast real estate management company) is the primary beneficiary.

In some rare circumstances, if the parties have divided the same activities in exactly the same proportions (e.g., three unrelated parties, whereby each manages 1/3 of equal rental properties), there may not be a party that controls the majority of the activities, and therefore no party will consolidate the VIE.

Example 3: Shared power in a joint venture

Big Beer Manufacturer (BBM) and Distribution Partners (DP) form a joint venture Slim Jim Beer (SJB) to manufacture, distribute and sell Slim Jim brand name beer in the United States. BBM and DP each have 50% of the voting rights (through 50% equity interest) and each controls 50% of the Board seats of SJB. The SJB venture is formed by the two parties; each party also provided a guarantee to a third party lender in order to obtain a loan.

BBM is responsible for manufacturing the Slim Jim beer within the United States and DP is responsible for distributing, selling and marketing (including developing the Slim Jim brand name in the US market). Despite this functional delineation of their general management responsibilities, both joint venture partners have to approve and consent to each other's major decisions. The SJB governing documents specify what types of decisions require mutual consent and the penalties to the party that acts without obtaining the consent of the other party appear to be substantive. The activities that require decision by consent outlined in the SJB governing documents are all of the activities that significantly impact the economic performance of the SJB joint venture.

SJB is a VIE because its equity at risk is insufficient to permit it to finance its activities without additional subordinated financial support. This is evident in the lender's unwillingness to extend credit without the guarantees provided by SJB's joint venturers. Since the two variable interest holders, BBM and DP, share power over the activities that most significantly impact the economic performance of SJB through consenting to each other's major decisions, neither one of them would hold a controlling financial interest and be deemed the primary beneficiary of the VIE.

However, if the two variable interest holders (BBM and DP) were related parties, they cannot share power over the activities that most significantly impact the economic performance of SJB, despite what appears to be a power sharing arrangement per the SJB governing documents. Since power is not shared, one of these two joint venturers would be deemed to direct the activities that most significantly impact the economic performance of SJB and would be designated as the primary beneficiary. If the activities directed by DP (distribution, marketing and local brand management) are considered more significant to the economic performance of the VIE than the manufacturing activity directed by BBM, then DP would be the related party designated as the primary beneficiary of the VIE on a stand-alone basis.

D1B. ECONOMIC INTEREST

The economic interest in the second characteristic of a party with controlling financial interest need only be potentially significant to the variable interest entity. That is, the probability of the economic interest becoming significant is not an appropriate basis for assessing whether a variable interest holder should consolidate a VIE. If the reporting enterprise has identified a variable interest in a VIE (step B), the variable interest will generally represent an economic interest that could potentially be significant to the VIE.[26]

D3A. WHICH ENTERPRISE FROM THE RELATED PARTY GROUP IS CONSIDERED "MOST CLOSELY ASSOCIATED" WITH THE VIE?

As discussed above, if applying the power and economic interest criteria to a reporting enterprise and its related parties leads to a conclusion that none of them individually qualifies as the primary beneficiary of the VIE (step **D1** and **D2**), the power and economic interest test has to be applied to the RE and its related parties and de-facto agents on a collective basis (step **D3**).

If the reporting enterprise and its related parties and de facto agents as a group meet the power and economic interest criteria in step **D3**, they are deemed to hold a controlling financial interest collectively. Only one entity from this related party group will be the primary beneficiary and consolidate the VIE – the party which is most closely associated with the VIE.

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:

- The existence of a principal-agency relationship between parties within the related party group
- The relationship and significance of the activities of the VIE to the various parties within the related party group
- A party's exposure to the variability associated with the anticipated economic performance of the VIE
- The design of the VIE.[27]

III. INITIAL ADOPTION OF LATEST VIE CONSOLIDATION GUIDANCE (ASU 2009-17)

In accordance with ASC 810-10-25-37, the initial determination of whether a legal entity is a VIE shall be made on the date on which a reporting enterprise first becomes involved with the legal entity. For purposes of the VIE model, involvement with a legal entity refers to ownership, contractual, or other pecuniary interests that may be determined to be variable interests. That determination shall be based on the circumstances on that date including future changes that are required in existing governing documents and existing contractual arrangements.

The amendments introduced by ASU 2009-17 are effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Earlier application is prohibited. 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 amended VIE guidance shall be presented too. For nonpublic entities, in periods after initial adoption, comparative disclosures previously required that are also required by the amended VIE guidance shall be presented.

If an enterprise is required to consolidate an entity for the first time as a result of the initial application of the amendments in ASU 2009-17, the consolidating enterprise shall initially measure the assets, liabilities, and non-controlling interests of the VIE at the carrying amounts these assets, liabilities and non-controlling interests would have been carried in the consolidated financial statements if ASU 2009-17 had been effective when the enterprise first met the conditions to be the primary beneficiary. If determining the carrying amounts is not practicable,[28] the assets, liabilities and any non-controlling interest of the VIE shall be measured and recorded at fair value at the date the ASU 2009-17 amendments first apply.[29]

Any difference between the net amount added to the balance sheet of the consolidating enterprise and the amount of any previously recognized interest in the newly consolidated VIE shall be recognized as a cumulative effect adjustment to retained earnings. A reporting

26 Decision maker and service provider fees may meet the exception in step B1.
27 ASC 810-10-25-44
28 In this context, "impracticable" is not defined. The conditions in ASC 250-10-45-9, which indicate when retrospective application of a change in accounting principle is impracticable, may be (but are not required to be) considered for transition purposes under ASU 2009-17.
29 ASC 810-10-65-2b also allows the initial measurement of assets and liabilities of the VIE to be performed at "unpaid principal balances" as defined in that paragraph 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 for the obligations of the entity.

entity shall describe the transition method(s) applied and shall disclose the amount and classification on its statement of financial position of the consolidated assets or liabilities by the transition method(s) applied.

A reporting enterprise that is required to consolidate a VIE as a result of the initial application of the amended VIE guidance may elect the fair value option provided by the Fair Value Option subsections of ASC Subtopic 825-10, only if the reporting enterprise elects the option for all eligible financial assets and financial liabilities of that VIE. The election shall be made on a VIE by VIE basis. Along with the disclosures required by ASC 825-10, the consolidating reporting enterprise shall disclose all of the following:

- Management's reasons for electing the fair value option for a particular VIE or group of VIEs
- The reasons for different elections if fair value option is elected for some VIEs and not others
- 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.

If an enterprise is required to deconsolidate an entity for the first time as a result of the initial application of ASU 2009-17, the deconsolidating enterprise shall initially measure any retained interest in the deconsolidated subsidiary at its carrying amount at the date the requirements of ASU 2009-17 first apply. In this context, carrying amount refers to the amount at which any retained interest would have been carried in the enterprise's financial statements if ASU 2009-17 had been effective when the enterprise became involved with the entity or no longer met the conditions to be the primary beneficiary. Any difference between the net amount removed from the balance sheet of the consolidating enterprise and the carrying amount of any retained interest in the entity shall be recognized as a cumulative effect adjustment to retained earnings.[30]

Refer to Appendix A of this VIE Practice Aid for a list of disclosures applicable a reporting enterprise's involvement with VIEs, including situations in which the reporting enterprise holds a variable interest in a VIE that it does not consolidate.

IV. CONSOLIDATION AND PRESENTATION OF A VIE

Consolidation of a VIE is accomplished using procedures similar to consolidation of a traditional majority-owned subsidiary based on voting interests. The assets, liabilities, revenues, expenses, and cash flows of the VIE are consolidated into the financial statements of the primary beneficiary. Any intra-entity balances and transactions (for example, rent income of the VIE and rent expense of the primary beneficiary reporting enterprise) are eliminated. In accordance with ASC 810-10-35-3, the effect of eliminating a VIE's income or expense arising from transactions with the primary beneficiary are attributed to the primary beneficiary, not to the non-controlling interest. The purpose of this guidance is to preserve the impact of intercompany income and expense in income attributable to the controlling interest (primary beneficiary) to the extent such amounts are realized. This differs from the consolidation guidance under the voting interest model outlined in ASC 810-10-45-18, in which the elimination of the intra-entity income or loss may be allocated between the parent and the non-controlling interests.

The following example demonstrates the difference in attributing the effect of the eliminating entries between the parent and the subsidiary in consolidation under the voting interest model and attributing the effect of eliminating entries between the primary beneficiary and the VIE under the variable interest entity consolidation model.

30 ASC 810-10-65-2e

Example 4

Assume that entity C is a VIE and has two variable interest holders A and B. A holds 20% of the equity in C and 100% of C's debt, whereas B holds 80% in the equity of C. A has concluded that it is the primary beneficiary of the VIE C. During the current fiscal period, A generated interest income of $3,000 from C.

The following table illustrates the consolidation of C in the financial statements of A if the voting interest model had applied:

	Company A	VIE C	Eliminations	Consolidated A
Revenue	$20,000	$3,000	–	$23,000
Cost of revenues	15,000	1,000	–	16,000
Operating margin	5,000[1]	2,000[2]	–	7,000
Other income (expense)				
Interest income	3,000	–	(3,000)	–
Interest expense	–	(3,000)	3,000	–
Net income (loss)	8,000	(1,000)	–	7,000
Net income attributable to non-controlling interest B (80% of item **2**)				1,600
Net income attributable to controlling interest A (100% of item **1** and 20% of item **2**)				5,400

The following table illustrates the consolidation of VIE C in the financial statements of A under the variable interest entity consolidation model:

	Company A	VIE C	Eliminations	Consolidated A
Revenue	$20,000	$3,000	–	$23,000
Cost of revenues	15,000	1,000	–	16,000
Operating margin	5,000	2,000	–	7,000
Other income (expense)				
Interest income	3,000	–	(3,000)	–
Interest expense	–	(3,000)	3,000	–
Net income (loss)	8,000[3]	(1,000)[4]	–	7,000
Net income attributable to non-controlling interest B (80% of item **4**)				(800)
Net income attributable to controlling interest A (100% of item **3** and 20% of item **4**)				7,800

Any ownership interests held by parties other than the primary beneficiary are displayed as non-controlling interests in the equity section of the balance sheet, separately from the primary beneficiary's equity. In some cases, the noncontrolling interest may be 100% of the entity's equity. A parent (i.e., the primary beneficiary) with one or more less-than-wholly-owned subsidiaries shall disclose all of the following for each reporting period:

- Separately, on the face of the consolidated financial statements, both of the following:
  - The amounts of consolidated net income and consolidated comprehensive income
  - The related amounts of each attributable to the parent and the noncontrolling interest.
- Either in the notes or on the face of the consolidated income statement, amounts attributable to the parent for any of the following, if reported in the consolidated financial statements:
  - Income from continuing operations
  - Discontinued operations
  - Extraordinary items.
- Either in the consolidated statement of changes in equity, if presented, or in the notes to consolidated financial statements, a reconciliation at the beginning and the end of the period of the carrying amount of total equity (net assets), equity (net assets) attributable to the parent, and equity (net assets) attributable to the noncontrolling interest. That reconciliation shall separately disclose all of the following:
  - Net income
  - Transactions with owners acting in their capacity as owners, showing separately contributions from and distributions to owners
  - Each component of other comprehensive income.

- In notes to the consolidated financial statements, a separate schedule that shows the effects of any changes in a parent's ownership interest in a subsidiary on the equity attributable to the parent.

PRESENTATION OF A VIE IN THE CONSOLIDATED FINANCIAL STATEMENTS

In some cases, the VIE consolidation guidance (ASC 810-10-45-25) requires specific assets and liabilities of a consolidated VIE to be presented separately on the consolidated balance sheet of the primary beneficiary. Specifically, a reporting entity shall present each of the following separately on the face of the statement of financial position:

- Assets of a consolidated variable interest entity (VIE) that can be used only to settle obligations of the consolidated VIE.
- Liabilities of a consolidated VIE for which creditors (or beneficial interest holders) do not have recourse to the general credit of the primary beneficiary.

A reporting enterprise has alternatives in presenting the assets and liabilities of a VIE, which meet the separate presentation criteria in ASC 810-10-45-25. Acceptable alternatives include (i) presenting the assets as one line item in the consolidated balance sheet of the primary beneficiary and parenthetically disclosing the amount of assets held by the VIE; and (ii) presenting the assets separately in the consolidated balance sheet of the primary beneficiary – one line item for the assets held in the VIE and the other line item for the assets held by the primary beneficiary and its other consolidated subsidiaries.

The FASB did not provide any requirements for separate presentation of a consolidated VIE's revenue, expense or cash flow figures.

Netting of VIE assets and liabilities that meet the separate presentation criteria in ASC 810-10-45-25 is not allowed.

For a reporting enterprise using the indirect method for the statement of cash flows, the starting point is net income (i.e., *not* net income from controlling interest), just as in any other consolidated statement of cash flows when both a controlling and non-controlling interest exist.

V. RECONSIDERATION EVENTS AND ONGOING PRIMARY BENEFICIARY ASSESSMENT

RECONSIDERATION OF ENTITY'S VIE STATUS

The initial determination of whether an entity is a variable interest entity shall be reconsidered if one or more of the following occur:

- The entity's governing documents or contractual arrangements are changed in a manner that changes the characteristics or adequacy of the entity's equity investment at risk.
- The equity investment at risk or some part thereof is returned to the equity investors, and other interests become exposed to expected losses of the entity (e.g., dividend distributions).
- The entity undertakes additional activities or acquires additional assets, beyond those that were anticipated at the later of the inception of the entity or the latest reconsideration event, that increase the entity's expected losses.
- The entity receives an additional equity investment that is at risk (e.g., equity owners reinvest their earnings into the company or add new equity financing to the entity), or the entity curtails or modifies its activities in a way that decreases its expected losses.
- Changes in facts and circumstances occur such that the holders of the equity investment at risk, as a group, lose the power from voting rights or similar rights of those investments to direct the activities of the entity that most significantly impact the entity's economic performance.

An example of last event would be an entity that was previously consolidated by reporting enterprise A under the voting interest model that experienced severe losses such that party B (e.g., guarantor or lender) obtained control of the entity. The entity, now a VIE, would be subject to the VIE consolidation guidance and evaluated for consolidation by party B.

Reconsideration of primary beneficiary status

The FASB decided to require an ongoing assessment of primary beneficiary status. In the past, variable interest holders reconsidered whether they were the primary beneficiary only when certain triggering events occurred. ASU 2009-17 eliminated this element of the variable interest entity model to align it with the voting interest approach. Now variable interest holders must monitor changing circumstances for their impact on the consolidation analysis. For example, when an entity engaged in drug development transitions from the research phase to commercial production, the activities that most significantly impact the VIE's economic performance would be expected to change. Decisions to consolidate or deconsolidate an entity should be reflected in the financial statements on the date circumstances change, and prior periods are not recast to conform to the current presentation.

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APPENDIX A – **DISCLOSURES ABOUT VARIABLE INTERESTS AND VARIABLE INTEREST ENTITIES**

The principal objectives of the required disclosures are to provide financial statement users with an understanding of all of the following:

- The significant judgments and assumptions made by a reporting enterprise in determining whether it must do any of the following:
  - Consolidate a VIE
  - Disclose information about its involvement in a VIE.
- The nature of restrictions on a consolidated VIE's assets and on the settlement of its liabilities reported by a reporting enterprise in its statement of financial position, including the carrying amounts of such assets and liabilities.
- The nature of, and changes in, the risks associated with a reporting enterprise's involvement with the VIE.
- How a reporting enterprise's involvement with the VIE affects the reporting enterprise's financial position, financial performance, and cash flows.

A reporting enterprise shall consider the overall objectives in the preceding paragraph in providing the disclosures required by ASC 810-10-50. To achieve those objectives, a reporting entity may need to supplement the disclosures otherwise required by ASC 810-10-50, depending on the facts and circumstances surrounding the VIE and a reporting entity's interest in that VIE.

The disclosures required by ASC 810-10-50 may be provided in more than one note to the financial statements, as long as the objectives are met. If the disclosures are provided in more than one note to the financial statements, the reporting entity shall provide a cross reference to the other notes to the financial statements that provide the disclosures prescribed in ASC 810-10-50 for similar entities.

Scope-related disclosures

A reporting enterprise that does not apply the guidance in the Variable Interest Entities Subsections to one or more VIEs or potential VIEs because of the condition described in paragraph 810-10-15-17(c) (that is, the entity qualifies for one of the following scope exceptions: not-for-profit, separate accounts of life insurers, created before December 31, 2003 or business) shall disclose all the following information:

- The number of legal entities to which the guidance in the Variable Interest Entities Subsections is not being applied and the reason why the information required to apply this guidance is not available
- The nature, purpose, size (if available), and activities of the legal entity or entities and the nature of the reporting entity's involvement with the legal entities
- The reporting entity's maximum exposure to loss because of its involvement with the legal entity or entities
- 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.

All reporting enterprises Involved with a VIE (Regardless of whether the RE is the primary beneficiary)

A reporting enterprise that is a primary beneficiary of a VIE or a reporting enterprise that holds a variable interest in a VIE but is not the entity's primary beneficiary shall disclose all of the following:

- Its methodology for determining whether the reporting enterprise is the primary beneficiary of a VIE, including, but not limited to, significant judgments and assumptions made. One way to meet this disclosure requirement would be to provide information about the types of involvements a reporting enterprise considers significant, supplemented with information about how the significant involvements were considered in determining whether the reporting enterprise is the primary beneficiary.
- If facts and circumstances change such that the conclusion to consolidate a VIE has changed in the most recent financial statements (for example, the VIE was previously consolidated and is not currently consolidated), the primary factors that caused the change and the effect on the reporting enterprise's financial statements.
- Whether the reporting enterprise has provided financial or other support (explicitly or implicitly) during the periods presented to the VIE that it was not previously contractually required to provide or whether the reporting enterprise intends to provide that support, including both of the following:
  - The type and amount of support, including situations in which the reporting entity assisted the VIE in obtaining another type of support
  - The primary reasons for providing the support.
- Qualitative and quantitative information about the reporting enterprise's involvement (giving consideration to both explicit arrangements and implicit variable interests) with the VIE, including, but not limited to, the nature, purpose, size, and activities of the VIE, including how the VIE is financed.

A VIE may issue voting equity interests, and the entity that holds a majority voting interest also may be the primary beneficiary of the VIE. If so, and if the VIE meets the definition of a business and the VIE's assets can be used for purposes other than the settlement of the VIE's obligations, the disclosures in the preceding paragraph are not required.

Reporting enterprise is the primary beneficiary of a VIE

The primary beneficiary of a VIE that is a business shall provide the disclosures required by other guidance (e.g., ASC 805). The primary beneficiary of a VIE that is not a business shall disclose the amount of gain or loss recognized on the initial consolidation of the VIE. The primary beneficiary of a VIE shall disclose all of the following (unless the primary beneficiary also holds a majority voting interest):

- The carrying amount and classification of the VIE's assets and liabilities in the statement of financial position that are consolidated in accordance with the guidance in the Variable Interest Entities Subsections of ASC 810, including qualitative information about the relationship(s) between those assets and associated liabilities. For example, if the VIE's assets can be used only to settle specific obligations of the VIE, the reporting entity shall disclose qualitative information about the nature of the restrictions on those assets.
- Lack of recourse if creditors (or beneficial interest holders) of a consolidated VIE have no recourse to the general credit of the primary beneficiary.
- Terms of arrangements, giving consideration to both explicit arrangements and implicit variable interests, that could require the reporting enterprise to provide financial support (for example, liquidity arrangements and obligations to purchase assets) to the VIE, including events or circumstances that could expose the reporting entity to a loss.

Non-primary beneficiary holder of a variable interest in a VIE

In addition to disclosures required by other guidance, a reporting enterprise that holds a variable interest in a VIE, but is not the VIE's primary beneficiary, shall disclose:

- The carrying amounts and classification of the assets and liabilities in the reporting entity's statement of financial position that relate to the reporting entity's variable interest in the VIE.
- The reporting enterprise's maximum exposure to loss as a result of its involvement with the VIE, including how the maximum exposure is determined and the significant sources of the reporting entity's exposure to the VIE. If the reporting enterprise's maximum exposure to loss as a result of its involvement with the VIE cannot be quantified, that fact shall be disclosed.
- A tabular comparison of the carrying amounts of the assets and liabilities, as required by (a) above, and the reporting enterprise's maximum exposure to loss, as required by (b) above. A reporting enterprise shall provide qualitative and quantitative information to allow financial statement users to understand the differences between the two amounts. That discussion shall include, but is not limited to, the terms of arrangements, giving consideration to both explicit arrangements and implicit variable interests, that could require the reporting enterprise to provide financial support (for example, liquidity arrangements and obligations to purchase assets) to the VIE, including events or circumstances that could expose the reporting entity to a loss.
- Information about any liquidity arrangements, guarantees, and/or other commitments by third parties that may affect the fair value or risk of the reporting enterprise's variable interest in the VIE is encouraged.
- If applicable, significant factors considered and judgments made in determining that the power to direct the activities of a VIE that most significantly impact the VIE's economic performance is shared in accordance with the guidance in paragraph 810-10-25-38D.

Aggregation of disclosures

Disclosures about VIEs may be reported in the aggregate for similar entities if separate reporting would not provide more useful information to financial statement users. A reporting enterprise shall disclose how similar entities are aggregated and shall distinguish between:

- VIEs that are not consolidated because the reporting enterprise is not the primary beneficiary but has a variable interest
- VIEs that are consolidated.

In determining whether to aggregate VIEs, the reporting enterprise shall consider quantitative and qualitative information about the different risk and reward characteristics of each VIE and the significance of each VIE to the entity. The disclosures shall be presented in a manner that clearly explains to financial statement users the nature and extent of the reporting enterprise's involvement with VIEs.