Consolidation and equity method of accounting

Fully updated May 2019
About this guide

PwC is pleased to offer our Consolidation and equity method of accounting guide. This guide has been updated as of May 2019.

This guide begins with a summary of the overall consolidation framework. The ensuing chapters further discuss the variable interest entity model, the voting interest entity model, and the equity method of accounting. This guide also discusses accounting for joint ventures as well as intercompany transactions and other matters.

This guide summarizes the applicable accounting literature, including relevant references to and excerpts from the FASB’s Accounting Standards Codification (the Codification). It also provides our insights and perspectives, interpretative and application guidance, illustrative examples, and discussion on emerging practice issues.

This guide should be used in combination with a thorough analysis of the relevant facts and circumstances, review of the authoritative accounting literature, and appropriate professional and technical advice.

References to US GAAP

Definitions, full paragraphs, and excerpts from the Financial Accounting Standards Board’s Accounting Standards Codification are clearly designated, either within quotes in the regular text or enclosed within a shaded box. In some instances, guidance was cited with minor editorial modification to flow in the context of the PwC Guide. The remaining text is PwC’s original content.

References to other PwC guidance

This guide provides general and specific references to chapters in other PwC guides to assist users in finding other relevant information. References to other guides are indicated by the applicable guide abbreviation followed by the specific section number. The other PwC guides referred to in this guide, including their abbreviations are:

- Bankruptcies and liquidations (BLG)
- Business combinations and noncontrolling interests (BCG)
- Derivative instruments and hedging activities (DH)
- Fair value measurements, global edition (FV)
- Financial statement presentation (FSP)
- Financing transactions (FG)
- Income taxes (TX)
- Stock-based compensation (SC)
Summary of significant changes

This guide considers guidance as of May 31, 2019. Additional updates may be made to keep pace with significant developments. Following is a summary of the noteworthy revisions to the Consolidation and equity method of accounting guide since it was issued in 2015.

**CG 1, The consolidation and equity method framework**

- Updates were made throughout CG 1 to reflect the guidance in ASU 2016-01, Recognition and Measurement of Financial Assets and Financial Liabilities.

  - Former CG 1.1.2 (new CG 1.1.1) was updated to abbreviate the history of the consolidation model and for the issuance of ASU 2018-17, Targeted Improvements to Related Party Guidance for Variable Interest Entities.

  - Former CG 1.2 was removed as the recent key changes noted in the first edition of this guide are incorporated into the appropriate sections of the consolidation guide.

**CG 2, Variable interest entity model**

- CG 2.1.2.5 and CG 2.2.4.2 were updated for the issuance of ASU 2018-17.

- CG 2.4.5 and CG 2.4.7 were updated for the issuance of ASU 2016-17, Interests held through related parties that are under common control.

- CG 2.4.6.2 was updated to include an example to illustrate the determination of whether a commonly controlled related party group meets both characteristics of a primary beneficiary.

- CG 2.5 was added to provide initial consolidation considerations.

- CG 2.5.1 was added to provide considerations for measuring the financial assets and liabilities of collateralized financing entities.

**CG 4, Equity method of accounting**

- CG 4.1, Figure 4-1, and Figure 4-6 were updated to reflect the guidance in ASU 2016-01.

- CG 4.2.3 was updated to include an SEC staff view, but the accounting treatment was not affected.

- Example 4-12, addressing equity accounting through direct and indirect interests, was added.

- CG 4.4, CG 4.4.1.1, CG 4.4.1.2, CG 4.4.1.3, CG 4.5.3.2, and CG 4.7.4 were updated to reflect the guidance in ASU 2017-05, Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets.

- CG 4.4.1.4, Contribution of intellectual property to a noncustomer (equity method), was added to reflect the guidance in ASU 2017-05.
CG 4.4.6 was updated and CG 4.4.6.1 was removed as a result ASU 2016-07, Simplifying the Transition to the Equity Method of Accounting.

CG 4.5.9, Distributions in excess of carrying amount of investment (equity method), was added.

CG 4.7.9, Investee transactions with noncontrolling interest holders, was added as a result of amendments to ASC 810 (formerly FAS 160) regarding changes in interest.

**CG 5, Joint ventures**

- CG 5.3.1.2 and CG 5.4.1 were updated to reflect the guidance in ASU 2017-05.
- CG 5.3.2.3 was updated to reflect the guidance in ASU 2016-01.

**CG 6, Intercompany transactions and other matters**

- CG 6.2 has been reorganized, which changed the numbering of subsections.
- Former CG 6.2.4 (new CG 6.2.5) and former CG 6.2.4.1 (new CG 6.2.5.1) were updated to reflect ASU 2015-11, Simplifying the Measurement of Inventory.
- CG 6.3 was updated to reflect ASU 2018-18, Clarifying the Interaction between Topic 808 and Topic 606.

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Chapter 1:  
The consolidation and equity method framework
1.1 **Background**

Determining when one entity should consolidate another can be complex. However, it is important to investors because when one entity consolidates another, it reports the other entity’s assets, liabilities, revenues, and expenses together with its own, as if they are a single economic unit. Consequently, the consolidation decision can significantly impact the reported leverage, results of operations, and cash flows of the consolidating entity.

In accounting, control is required for one entity to consolidate another. The definition of control, therefore, is the foundation for a consolidation model.

1.1.1 **Evolution of two consolidation models**

The original US consolidation standard, issued in the 1950s, was based on the notion that control was generally demonstrated by holding a majority of the voting rights of an entity. This consolidation model, which is still used today, is commonly referred to as the voting interest model.

Later, a separate model, within the broader voting interest model, was developed for limited partnerships and similar entities that were not considered variable interest entities. That model included the presumption that the general partner controlled a partnership unless the limited partners were able to remove the general partner by a simple majority vote.

See CG 3 for details on the voting interest consolidation model.

The use of securitizations, a process to bundle financial assets into securities, increased during the 1990s and 2000s, as did the use of structures, commonly referred to as “special purpose entities,” which were not consolidated under the existing guidance. Some high profile perceived abuses of the consolidation rules in the early 2000s resulted in a “risks and rewards model.” This model is referred to as the variable interest entity (VIE) model.

The VIE model provided that if an entity expected to assume more than 50% of another entity’s expected losses or gains, it should consolidate that entity. This model had the effect of creating a “bright line,” allowing entities to structure transactions to achieve their objective—either to consolidate another entity or not. For example, an entity could effectively control another entity by making all of the investment decisions and obtaining a considerable portion of the economic benefits, but would not have been required to consolidate that investee if it was exposed to less than 50% of the investee’s expected losses or gains. An additional revision and further guidance was issued subsequently to address some of the implementation questions that arose with this risk and rewards approach to the VIE model.

The financial crisis that began in 2008 provided another catalyst for change as some financial institutions recognized losses related to entities that were off balance sheet. Stakeholders called for greater transparency into these entities, and in response, the control definition for variable interest entities changed from one focused exclusively on risks and rewards to one focused on having both the power to direct an entity’s key activities and exposure to potentially significant gains and losses (a “power and economics” model).

Subsequently, the VIE model has been amended to address concerns of asset managers, provide relief for private companies in certain circumstances, alter how a decision maker needs to consider indirect
interests in a VIE held through an entity under common control, eliminate the exception for certain
development stage entities from being considered variable interest entities, and provide a
measurement alternative for consolidated collateralized financing entities.

In October 2018, the FASB issued ASU 2018-17, which expands the application of the private company
accounting alternative related to VIEs and changes the guidance for determining whether a decision-
making fee is a variable interest. Under ASU 2018-17, a private company can make an accounting
policy election to not apply the VIE guidance to all legal entities under common control if neither the
parent or the legal entity being evaluated for consolidation are public business entities. ASU 2018-17
also provides that indirect interests held through related parties under common control are considered
on a proportional basis when determining whether fees paid to decision makers and service providers
are variable interests.

ASU 2018-17 will be effective for public companies for fiscal years beginning after December 15, 2019
and interim periods within those fiscal years. For private companies, the new guidance will be effective
for fiscal years beginning after December 15, 2020 and interim periods within fiscal years beginning
after December 15, 2021. Retrospective adoption is required. Early adoption is permitted, including
adoption in an interim period.

See CG 2 for details on the VIE consolidation model.

1.1.2 **Equity method of accounting**

The equity method of accounting is an approach for an investor to measure investments in common
stock or other eligible investments in an investee entity (i.e., investments considered to be
substantively similar to common stock, such as certain preferred stock investments) by recognizing its
share of the net assets underlying those investments. It also requires the investor to recognize, in net
income, its share of the investee’s earnings for each reporting period. The equity method of accounting
is required when an investor or a company is able to exercise significant influence over the operating
or financial decisions of an investee.

The equity method of accounting guidance also addresses many other items, including:

- An investor’s accounting for subsequent investments in an investee after suspending equity
  method loss recognition
- Stock-based compensation granted by an investor to employees of the investee, exchanges of
  equity method investments
- The determination of when limited partnerships and limited liability companies should be subject
to the equity method
- The receipt of an equity method investment for the contribution of nonfinancial assets

See CG 4 for details on the equity method of accounting.
1.1.3 Joint venture accounting

Historically, the equity method was commonly applied to investments in joint ventures. The subsequent introduction of the VIE risks and rewards model led to some entities no longer being viewed as joint ventures and instead needing to be consolidated by one of the venturers.

Today, the starting point for assessing an investment, including one in a joint venture, is the consolidation guidance. An investor in a joint venture needs to first determine if it has a controlling financial interest and, if so, would need to consolidate the venture.

Some nuances have evolved in practice in the accounting for investments in joint ventures under the equity method and the accounting by the joint venture entity. These differences arise predominantly in the accounting for non-cash contributions to the joint venture. See CG 5 for further discussion on the accounting by joint ventures and for investments in joint ventures.

Proportionate consolidation is used in limited circumstances in the extractive and construction industries as an alternative to the equity method. See CG 6 for further discussion on proportionate consolidation.

1.2 The consolidation and equity method framework

This section provides a summary of the consolidation and equity method of accounting framework. It also addresses matters that are a precondition to assessing an entity for consolidation, in particular, how to determine if there is a legal entity and when a legal entity is scoped out of the consolidation assessment. Detailed application of the VIE and voting interest entity consolidation models and the equity method of accounting are addressed in separate chapters of this guide.

1.2.1 Overview of the consolidation and equity method framework

Whenever a reporting entity has a financial relationship with a legal entity, it should evaluate whether the entity should be consolidated or accounted for under the equity method. In the context of consolidation, a reporting entity must have a “variable interest” in the other entity to assess whether consolidation is required. Loosely defined, a variable interest is a financial relationship that exposes the reporting entity to the risks and/or rewards of (variability in) the entity’s assets and operations. See CG 2.2 for further discussion of what constitutes a variable interest.

An equity investment is not the only means by which an investor can obtain a controlling financial interest in an entity. While it is the most common form of variable interest through which a controlling financial interest is obtained, many other relationships can also provide control over an entity. For example, a company that provides financing or credit support, such as a lender, lessor, or guarantor, is generally exposed to the risk that the entity’s assets or operations do not perform and consequently the entity is unable to meet its obligations. This type of arrangement may establish a controlling financial interest over the entity.

There are some instances that exempt a reporting entity from assessing whether it needs to consolidate another entity due to its financial relationships. These scope exceptions are discussed in CG 1.2.3.

When a reporting entity has an investment that does not give it a controlling financial interest in the entity, it may need to consider if the equity method of accounting applies. The equity method applies
An introduction to the consolidation and equity method framework

to investments in common stock or “in substance” common stock when the reporting entity is able to exercise significant influence over the investee. Eligible investments also include interests in limited partnerships.

Only after a reporting entity has determined that its financial relationship with an entity does not give rise to a controlling financial interest or an equity method investment, would it look to other accounting guidance to determine the appropriate accounting for that relationship. Other guidance that may be applicable includes the accounting for receivables (ASC 310), debt securities (ASC 320), equity securities (ASC 321), other investments (ASC 325), contingencies (ASC 450), guarantees (ASC 460), collaborative arrangements (ASC 808), derivatives (ASC 815), and other industry-specific guidance.

**Figure 1-1**
Summary decision tree

- Is the counterparty a legal entity (see CG 1.2.2)?
  - Yes
  - Does the reporting entity have a variable interest in the entity (see CG 2.2)?
    - Yes
    - Does the reporting entity have a controlling financial interest over the legal entity (see CG 2 and CG 3)?
      - Yes
      - Is the reporting entity’s variable interest common stock or in substance common stock, including partnership interest (see CG 4.2)?
        - Yes
        - Does the reporting entity have significant influence over the entity (see CG 4.3)?
          - Yes
          - Consolidate
          - Apply equity method (see CG 4 and CG 5)
        - No
          - Apply other accounting guidance (e.g., ASC 321, ASC 815, collaboration arrangements – see CG 6.3)
          - No
          - No
          - No
          - No
          - No
          - No

- No
  - No
  - No
1.2.2 Legal entity definition (consolidation)

Any legal entity, regardless of its legal form or scope of its activities, is subject to potential consolidation or application of the equity method of accounting absent an applicable scope exception. The ASC Master Glossary provides the following definition of a legal entity.

Definition of Legal Entity from ASC Master Glossary
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.

The definition of legal entity is expansive and intentionally broad. It includes all legal structures established to manage or administer activities of any kind, or to hold assets or incur liabilities. However, the term does not extend to individuals.

Concluding that an arrangement involves a legal entity requires that all relevant facts be considered. To illustrate:

- A franchise agreement may be entered into between the franchisor and an individual. This arrangement does not fall within the scope of the consolidation or equity method models, as the franchisee is a person. On the other hand, if the franchise agreement is between the franchisor and a legal entity (e.g., a corporation, partnership, limited liability company, or unincorporated entity), the legal entity would be subject to potential consolidation or the equity method by the franchisor even when the franchisee is wholly owned by an individual.

- In the insurance industry, it is common practice to use syndicates to accept insurance business on behalf of the syndicate's members. Depending on the legal form of the structure, some syndicates may involve a legal entity (e.g., a partnership). Other syndicate arrangements may pose no consolidation or equity method implications, as no legal structure or form is used to affect the members' underwriting activities.

Other situations exist where multiple parties jointly undertake an endeavor that is not wholly or partially conducted through a separate legal entity. The guidance for collaboration arrangements may apply in those instances and is further discussed in CG 6.3.

1.2.2.1 Factors that impact the legal entity determination (consolidation)

Determining whether an entity is a legal entity potentially subject to consolidation or the equity method may require the exercise of judgment. The determination is often obvious, such as when there is an incorporated legal entity (e.g., a corporation). Other times it may be less clear.

Factors to consider when evaluating whether a structure is a legal entity include whether:

- It meets the definition of a legal entity in the resident country. Even if it does not, the structure may have characteristics similar to those of a legal entity in the US. For example, an unincorporated foreign joint venture may have characteristics similar to those of a US partnership or limited liability company.
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- It is permitted to enter into contracts under its own name (i.e., not in the name of the partners or parent company)

- It has legal standing to enforce contracts or exercise creditor rights and, conversely, can be sued on a standalone basis

- The liability of the partners or investors are limited, or the liabilities of the structure flow through to the partners

- It is recognized for tax purposes, such as if a tax return is filed in the structure's name

- It can open a bank account in its own name

It may be necessary to seek the advice of an attorney to fully understand the legal characteristics of the structure and to clarify what activities the structure can legally undertake on a standalone basis. Additionally, it is possible that one indicator may not be conclusive in judging whether the entity is, in fact, a legal entity.

All relevant factors should be considered and the analysis may differ depending on the structure being evaluated. For example, ASC 810-10-55-8A through ASC 810-55-8H is an example of mutual funds under the Investment Company Act of 1940 that are structured as separate series within an overall umbrella legal entity (trust). Each series fund is represented by a separate share class of the trust or corporation and the proceeds from the issuance of the share class are invested in assets according to the strategy of the series fund. In a series mutual fund that is subject to the 1940 Act, the trust or corporation is governed by a single board of directors that is responsible for overseeing the operations of each series fund.

In the example, each separate series 1940 Act mutual fund is determined to be a legal entity based on each series fund having its own:

- Investment objectives and policies

- Custodial agreement

- Shareholders, separate from other series funds

- Unique tax identification number

- Separate tax returns filed with the Internal Revenue Service

- Separate audited financial statements

- Investor protections in virtually all circumstances (afforded under the 1940 Act by the SEC staff's Division of Investment Management)

These factors may not be present in other similar series structures, including in other jurisdictions. As a result, in other situations the umbrella legal entity may be the only level at which the consolidation or equity method guidance should be considered.
Within the VIE model, a portion of a legal entity, referred to as a “silo,” may also be deemed to be subject to potential consolidation. See CG 2.2.8 for more information.

1.2.3 **Exceptions to consolidation**

Investors and other variable interest holders in certain specified legal entities (e.g., employee benefit plans sponsored by employers) are exempt from evaluating those entities for consolidation under any consolidation model. In addition, certain legal entities are exempt from evaluating investees in which they hold a variable interest for consolidation under any consolidation model (e.g., investment companies). The exceptions were provided principally because consolidation of these entities would not provide the most relevant information to investors about the assets, liabilities, and operations of the reporting entity.

Care should be taken to understand which reporting entity is subject to an exception. These exceptions are discussed below.

In addition, specified legal entities (e.g., not-for-profit entities and certain businesses) are excluded only from the VIE consolidation evaluation, as discussed in CG 2.1.2. Those entities may still be evaluated for potential consolidation under the voting interest consolidation model discussed in CG 3.

1.2.3.1 **Employers’ interests in employee benefit plans (consolidation)**

An employer that sponsors an employee benefit plan is exempt from consolidating that plan.

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

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

Non-leveraged employee stock ownership plans (ESOPs) are defined contribution plans and are similar in important respects to pension arrangements covered by ASC 715, *Compensation—Retirement Benefits* (ASC 715). Consequently, we believe that non-leveraged ESOPs are also excluded from the consolidation model under this scope exception.

Note that this scope exception does not apply to a service provider who is not the sponsoring employer to an employee benefit plan. The service provider is obligated to perform its consolidation evaluation of the plan based on applying the relevant consolidation guidance.

Although an employer that sponsors an employee benefit plan is not required to consolidate that plan, the exception does not extend to an employee benefit plan itself. However, defined-benefit plans that fall within the scope of ASC 960, *Plan Accounting—Defined Benefit Pension Plans* (ASC 960), and defined-contribution plans that fall within the scope of ASC 962, *Plan Accounting—Defined Contribution Pension Plans* (ASC 962), should continue to follow the guidance of ASC 960 and ASC 962, respectively. We do not believe that it is intended to require employee benefit plans to consolidate entities in which they invest.

1.2.3.2 **Investment companies (consolidation)**

Investment companies generally are not required to evaluate their investees for consolidation.
An introduction to the consolidation and equity method framework

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

Except as discussed in paragraph 946-810-45-3, an investment company within the scope of Topic 946 [Financial Services-Investment Companies] shall not consolidate an investee that is not an investment company.

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 and are reported at fair value.

The scope exception does not apply to reporting entities that hold interests in an investment company. An investor, investment adviser, or any other party having an interest in an investment company entity under ASC 946 must evaluate whether it should consolidate the investment company or account for its investment using the equity method.

A reporting entity that consolidates an investment company retains the investment company’s specialized accounting in the reporting entity’s consolidated financial statements, as noted in ASC 810.

**ASC 810-10-25-15**

For the purposes of consolidating a subsidiary subject to guidance in an industry-specific Topic, an entity shall retain the industry-specific guidance applied by that subsidiary.

Similarly, a reporting entity that applies the equity method of accounting to an investment in an investment company would also retain the investee’s specialized accounting as noted in ASC 323, Investments—Equity Method and Joint Ventures. See also CG 4.5.6.3.

**ASC 323-10-25-7**

For the purposes of applying the equity method of accounting to an investee subject to guidance in an industry-specific Topic, an entity shall retain the industry-specific guidance applied by that investee.

### 1.2.3.3 Governmental organizations (consolidation)

In most cases, it would be inappropriate for a reporting entity to consolidate a governmental organization or a financing entity established by a governmental organization. There may be limited circumstances where consolidation of a financing entity established by a governmental organization may be appropriate, as discussed in the guidance below.

The VIE model does not apply to a governmental organization when assessing whether or not that governmental organization should consolidate another entity since the Governmental Accounting Standards Board (GASB) establishes the accounting rules for state and local governmental organizations.
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 meets both of the following conditions:

1. Is not a governmental organization

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

The term governmental organization is described in the AICPA Audit and Accounting Guide.

Excerpt from the AICPA State and Local Government Audit Guide 1.01

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

- 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.

Excerpt from AICPA State and Local Government Audit Guide 1.02

Organizations are governmental or nongovernmental for accounting, financial reporting, and auditing purposes based solely on the application of the preceding 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 IRC Section 501 is not a criterion in determining whether an entity is governmental or nongovernmental for accounting, financial reporting, and auditing purposes.

Whether an entity is a governmental organization or a financing entity established by a governmental organization requires careful consideration. Examples of governmental entities that would not be subject to consolidation include, but are not limited to:

- A governmental organization (or a financing entity established by a governmental organization) that issues tax-exempt debt to finance the construction of an asset leased to the reporting entity
A tax-increment financing entity established by a municipality to finance certain infrastructure assets on land owned by the reporting entity (commonly referred to as industrial development bonds).

In practice, the governmental scope exception can be difficult to apply, particularly when dealing with an entity established by a governmental organization to finance a project of the reporting entity. If an entity does not meet the definition of a governmental organization, further consideration should be given to whether the entity is, in substance, a financing entity established by a governmental organization. This analysis is subjective and requires an understanding of all of the facts and circumstances.

Although not intended to be all inclusive, some of the factors that may warrant consideration when making the determination of whether an entity is a governmental organization include:

- What was the extent and nature of the government’s involvement in establishing the entity?
- What role, if any, did the government play in selecting the entity’s board members (and/or selecting individuals responsible for directing the activities of the entity)?
- Does the government have the right to unilaterally dissolve the entity?
- What percent (or relative magnitude) of the entity’s activities are conducted 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 to the entity?

In addition, consideration should be given to whether the entity was set up to circumvent the VIE model for the purpose of obtaining off-balance sheet treatment for the reporting entity. When making this assessment, the intent and purpose of the entity, as well as whether the reporting entity was involved in the entity’s design should be considered.

Example 1-1 illustrates the application of the governmental scope exception.

**EXAMPLE 1-1**

**Governmental organization scope exception**

Entity A was formed through a competitive bidding process (overseen by a governmental entity) to issue revenue bonds to finance the construction of a power plant (the “facility”). Although Entity A legally owns the facility, the facility was constructed for the sole benefit of a governmental entity.

The owners of Entity A selected to issue the revenue bonds are in the business of managing power plants. The facility was constructed on government-owned land, with the land being leased to Entity A for the estimated life of the facility. At the end of the land lease term, 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 Entity A that requires the governmental organization to purchase 100% of the output of the facility, i.e., electricity, on a long term basis. The governmental entity also holds a fair value purchase option that allows it to purchase the facility from Entity A at any time during the lease term.

As part of a competitive bidding process, Company X, a party that is unrelated to Entity A or to the governmental entity, entered into an arrangement with Entity A to guarantee the revenue bonds.

Does Entity A qualify for the governmental organization scope exception?

**Analysis**

Factors that suggest Entity A is a financing entity established by a governmental organization include (1) the governmental entity was integral in the design and is a party to all the critical agreements of Entity A, (2) Entity A was established to finance and construct a power plant whose entire output is intended to be sold to that governmental entity, and (3) it is intended that the governmental entity will ultimately own Entity A’s assets. As a result, even though Entity A would not meet the GASB or Federal Accounting Standards Advisory Board (FASAB) definition of a governmental organization, it is likely that Company X would conclude that Entity A is a financing entity established by a governmental organization and, therefore, meets the governmental organization scope exception to the VIE consolidation model. Consequently, Company X would not be required to consider whether Entity A is a VIE.

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### 1.2.3.4 Money market funds (consolidation)

The money market funds scope exception applies to all investors and other variable interest holders in a qualifying fund.

**ASC 810-10-15-12(f)**

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

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

2. A reporting entity subject to this scope exception shall disclose any explicit arrangements to provide financial support to legal entities that are required to comply with or operate in accordance with requirements that are similar to those included in Rule 2a-7, as well as any instances of such support provided for the periods presented in the performance statement. For purposes of applying this disclosure requirement, the types of support that should be considered include, but are not limited to, any of the following:
   
   i. Capital contributions (except pari passu investments)
ii. Standby letters of credit

iii. Guarantees of principal and interest on debt investments held by the legal entity

iv. Agreements to purchase financial assets for amounts greater than fair value (for instance, at amortized cost or par value when the financial assets experience significant credit deterioration)

v. Waivers of fees, including management fees.

Registered money market funds are required to invest in securities issued by entities with minimal credit risk with a short duration (considering individual securities and the average maturity of the portfolio). In addition, they are subject to constraints related to credit risk and diversification.

Unregistered money market funds that operate in a manner similar to registered money market funds are also eligible for the scope exception. Determining whether an unregistered money market fund is similar to a registered money market fund will require judgment. The unregistered money market fund’s purpose and design, as well as the risks it was designed to create and pass along to its interest holders, should be considered in assessing whether the fund operates in a manner similar to a registered money market fund. The structure and intended outcome of the fund may also be relevant factors to consider.

Therefore, in assessing whether an unregistered fund is similar to a registered fund, the quality, maturity, and diversification of the fund’s portfolio should be considered. The following questions may be helpful.

**Figure 1-2**
Assessing unregistered money market funds

<table>
<thead>
<tr>
<th>Characteristic</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Portfolio quality</td>
<td>Does the fund invest in high-quality, short-term securities with credit risk similar to those held by registered money market funds?</td>
</tr>
<tr>
<td>Portfolio maturity and diversification</td>
<td>Are the fund’s objectives consistent with the objectives of a registered money market fund? In particular, with regard to the:</td>
</tr>
<tr>
<td></td>
<td>(1) Credit quality of its eligible investments</td>
</tr>
<tr>
<td></td>
<td>(2) Diversification of the portfolio</td>
</tr>
<tr>
<td></td>
<td>(3) Maximum maturity of eligible investments</td>
</tr>
<tr>
<td></td>
<td>(4) Average maturity of the portfolio</td>
</tr>
</tbody>
</table>

ASC 810-10-15-12(f) requires reporting entities with explicit arrangements to provide financial support, or that have provided financial support, to entities subject to this exception, to provide specified disclosures. See also FSP 18.
1.3 **The consolidation models**

There are two primary consolidation models in US GAAP – the variable interest entity (VIE) and voting interest entity models.

### 1.3.1 Determining which consolidation model applies

A reporting entity that has a variable interest in a legal entity not subject to a scope exception would need to first determine whether the VIE model applies. Only if the entity is determined to not be a VIE would the voting interest entity model be applied.

The following figure illustrates the general framework to be applied once a variable interest in a legal entity has been identified.

**Figure 1-3**
Consolidation framework decision tree

#### 1.3.1.1 The variable interest entity model (consolidation)

**Exceptions to the variable interest entity model**

Some entities may be subject to evaluation under the consolidation guidance, but are exempt from being evaluated for consolidation under the VIE model. In these circumstances, the entity would need to be evaluated for consolidation under the voting interest model. See CG 2.1.2 for these scope exceptions.
The five characteristics of a variable interest entity

There are five principle reasons that an entity would be deemed to be a variable interest entity (VIE) and subject to that consolidation model. These are commonly referred to as the characteristics of a VIE. If any one of these is present, then the entity needs to be evaluated for consolidation under the VIE model.

The characteristics aim to capture those situations where it would be inappropriate to look to only voting rights for determining whether a reporting entity has a controlling financial interest. The first characteristic acknowledges that when an entity is insufficiently capitalized, it may be the debt holders or other variable interest holders who have control. The second characteristic identifies those situations where the equity holders do not have voting rights over the activities of the entity that matter (nonsubstantive voting). The third characteristic identifies situations where the voting rights of the equity holders are not proportionate to their economic interests. The final two characteristics capture those situations where the equity holders are not exposed to the residual losses or benefits that one would normally associate with equity investors.

The VIE model is typically applied to entities that are formed for a predefined limited purpose, such as securitizations and asset-backed financing entities. However, the VIE model may also apply to typical operating companies and joint ventures. For example, contractual arrangements may be used to convey control over an operating entity when equity ownership is precluded for legal or regulatory reasons. Or, equity holders may not be fully exposed to the entity’s benefits or losses due to a cost plus or guarantee arrangement.

See CG 2.3.3 for a detailed discussion of each of the characteristics.

Overview of the variable interest entity model

Within the VIE model, the party that is determined to have a controlling financial interest is referred to as the primary beneficiary. The primary beneficiary is defined as being the party that has both of the following criteria:

□ Power to direct the activities of the entity that most significantly impact the entity’s economic performance (the power criterion)

□ The obligation to absorb losses of the entity, or the right to receive benefits of the entity, that could be potentially significant to the entity (the economics criterion)

The primary beneficiary analysis requires the exercise of judgment. Depending on the entity being assessed, one of the criteria may require more analysis than the other. For example, in a joint venture, it is often clear that the venturers all have a significant economic interest in the entity and therefore determining the primary beneficiary hinges on which party has power. In contrast, in a financial entity, such as a securitization, it may be clear that a servicer has decision making power and therefore determining the primary beneficiary will hinge on whether the servicer has a potentially significant economic exposure to the entity.

The level of economic exposure needed to be a primary beneficiary is well below that of a majority. This is in sharp contrast to the voting interest entity model where, since voting rights and economic interests are usually aligned, consolidation typically is not required when a reporting entity is not exposed to a majority of the economics of an entity. In addition, the assessment of what is a potentially
significant economic exposure is not solely a quantitative assessment. See CG 2.4 for detailed discussion on the primary beneficiary assessment under the VIE model.

The VIE model specifies how to consider related parties. Related parties can have a significant impact on the ultimate consolidation conclusion. The related party guidance in the VIE model is applied differently when there is a single party with decision making power versus when power is shared between two or more parties. Even when a reporting entity is not the primary beneficiary on a standalone basis, it may still need to consolidate the entity if its related party group has control and it is deemed to be the party that is most closely associated with the entity, based on a concept referred to as the related party tiebreaker. See CG 2.4 for a detailed discussion on the related party and related party tiebreaker considerations under the VIE model.

1.3.1.2 The voting interest entity model (consolidation)

Overview of the voting interest entity model

A reporting entity that has a variable interest in a legal entity may need to assess that legal entity for consolidation under the voting interest entity model. The voting interest entity model would apply either because (1) the legal entity does not have one of the five characteristics of a VIE (see CG 1.3.1.1. above), or (2) the entity or reporting entity is subject to a scope exception from the VIE model (see CG 2.1.2). An evaluation is only required under one of the models. The voting interest model should not be applied in instances where the investor determines it has a variable interest in a VIE but is not required to consolidate.

Under the voting interest model, for legal entities other than partnerships, the usual condition for control is ownership, directly or indirectly, of more than 50% of the outstanding voting shares over an entity. For limited partnerships and similar entities, the usual condition for control is ownership, directly or indirectly, of more than 50% of a limited partnership’s kick-out rights. However, substantive participating rights held by the noncontrolling interest holders would preclude the holder of the majority voting or kick-out rights from having a controlling financial interest. Substantive participating rights are those rights that enable the holder to block or participate in certain significant financial and operating decisions of the entity that are made in the ordinary course of business.

There are other situations where a holder of the majority voting rights may not have a controlling financial interest. For example, this could occur when an entity files for bankruptcy or otherwise becomes subject to the control of a government, court, administrator, or regulator. See BLG 3.17 for a discussion of consolidation considerations when an entity files for bankruptcy.

Control by contract

Within the voting interest entity model, there is guidance to accommodate entities that may be controlled through a contractual arrangement. This “control by contract” was initially developed specifically for physician practice management structures at a time when the VIE model did not exist, but the model is not limited in scope to physician practice management structures. Today, most physician practice management structures and other entities controlled through a contractual arrangement fall within the VIE model. Consequently, few structures seen today fall within the control by contract guidance. See CG 3.6 for a detailed discussion on the control by contract voting model.

See CG 3 for a detailed discussion on the voting interest entity model.
### Comparison of the variable and voting interest entity models

The following figure summarizes some of the more notable differences between the two broader consolidation models.

**Figure 1-4**  
Key differences between the variable interest entity and voting interest entity models

<table>
<thead>
<tr>
<th>Area</th>
<th>Voting interest entity model</th>
<th>Variable interest entity model</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Definition of control</strong>&lt;br&gt;(controlling financial interest)</td>
<td>For legal entities other than partnerships, the usual condition for control is ownership, directly or indirectly, of more than 50% of the outstanding voting shares over an entity&lt;br&gt;For limited partnerships and similar entities, the usual condition for control is ownership, directly or indirectly, of more than 50% of a limited partnership's kick-out rights (i.e., having the ability to replace the general partner or to liquidate the entity)</td>
<td>A party has control if it has both:&lt;br&gt;□ Power to direct the activities of the entity that most significantly impact the entity's economic performance&lt;br&gt;□ The obligation to absorb losses of the entity, or the right to receive benefits of the entity, that could be potentially significant to the entity</td>
</tr>
<tr>
<td><strong>Related party considerations</strong></td>
<td>No specific guidance</td>
<td>Interests held by related parties have the potential to impact a number of areas, including whether:&lt;br&gt;□ A decision maker has a variable interest (assessing whether other economic interests held by the decision maker are more than insignificant)&lt;br&gt;□ An entity is a VIE (as discussed in CG 2.3.3-3, characteristic 3)&lt;br&gt;□ A single decision maker is the primary beneficiary on a standalone basis (the indirect interest concept)&lt;br&gt;□ The related party tiebreaker needs to be applied&lt;br&gt;□ A non-decision maker is the primary beneficiary within a related party group with a single decision maker (the substantially all concept)</td>
</tr>
<tr>
<td>Area</td>
<td>Voting interest entity model</td>
<td>Variable interest entity model</td>
</tr>
<tr>
<td>---------------------</td>
<td>---------------------------------------------------------------------------------------------</td>
<td>----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Participating rights</td>
<td>Defined as rights to block or participate in certain significant financial and operating decisions of the entity that are made in the ordinary course of business</td>
<td>Defined as rights to block or participate in actions through which power to direct the activities that most significantly impact the entity’s performance are exercised To be substantive and preclude the party with decision making power from consolidating, the participating rights must enable the holder to participate in all significant activities, and must be unilaterally exercisable by a single party</td>
</tr>
<tr>
<td></td>
<td>Substantive participating rights over a significant activity (e.g., budgets) held by a noncontrolling investor preclude the majority shareholder from consolidating</td>
<td></td>
</tr>
<tr>
<td></td>
<td>The voting interest definition of participating rights is applied for determining if a limited partnership is a VIE</td>
<td></td>
</tr>
<tr>
<td>Disclosures</td>
<td>Limited required disclosures for consolidated subsidiaries that are voting entities; however consideration is given to disclosures on key judgments (see FSP 18.5)</td>
<td>Incremental disclosures are required for reporting entities that are the primary beneficiary and also for other reporting entities that hold variable interests in a VIE. In addition, incremental disclosures about support arrangements and financial support provided to money market funds are required (see FSP 18 for further discussion on the disclosures)</td>
</tr>
</tbody>
</table>

1.4 **The equity method of accounting**

The equity method of accounting prescribes an approach for an investor to measure investments in common stock or in-substance common stock by recognizing the investor’s share of the underlying net assets of those investments. The equity method applies when an investor does not control an investee, but instead is able to exert significant influence over the operating and financial policies of an investee. Determining if an investor can exercise significant influence requires the exercise of judgment.

Under the equity method, the investor should record each acquisition of its investment at cost, except when an investor receives an equity method investment as consideration for loss of control of a nonfinancial asset or business, or for transfer of an equity method investment, which are recorded at fair value. At each reporting period, the investor would adjust the carrying value of its investment to reflect, among other items, its proportionate share of the investee’s income (debit to investment account) or loss (credit to investment account), with a corresponding credit or debit, respectively, to equity in earnings (income statement).

The equity method can be complex to apply in practice. See CG 4 for a detailed discussion on the equity method of accounting. In addition, some nuances arise when the equity method is applied to joint ventures. See CG 5 for a further discussion on joint ventures.

An investor would not apply the equity method when it has elected to measure an investment at fair value on a recurring basis (the fair value option) or is applying the proportionate consolidation method allowed in limited circumstances in certain industries. See CG 4.2.5 for a discussion on the fair value option, and CG 6.4 for a discussion of the proportionate consolidation method.
1.5 **Accounting subsequent to consolidation**

1.5.1 *When to reassess previous consolidation conclusions*

The assessment of whether a reporting entity has a controlling financial interest in an entity is performed on an ongoing basis, irrespective of the consolidation model being applied. Similarly, the assessment of whether an investment needs to be accounted for on the equity method of accounting is performed on an ongoing basis. No exception is provided for instances where a reporting entity only temporarily controls or temporarily exercises significant influence over an entity.

An entity would continue to be assessed for consolidation under the VIE or voting interest entity models based on the most recent determination of which model applies. However, the applicable consolidation model to apply may change on the occurrence of a triggering event. See CG 2.3.4 for further discussion of triggering events.

1.5.2 *Considering changes in interest in consolidation assessments*

A change in an investor’s ownership interest can arise from several different types of transactions. The investor may purchase additional interests from or sell a portion of its existing interest to another investor or the investee. The investor’s interest may also change if the investee itself issues shares to or buys shares from other investors or issues shares upon the exercise of employee stock options.

The accounting for changes in interest will depend on the implications of that change. For instance, when a reporting entity gains control (consolidates) or loses control (deconsolidates), the change is reflected prospectively from the date at which control transfers. A change in interest that results in significant influence being retained is also accounted for prospectively from the date of the change.

A change in ownership interest could cause an investment to qualify for the equity method of accounting for the first time or may result in the investor no longer having significant influence, and as a result, no longer qualify for the equity method. An event that causes a reporting entity to move from financial instrument accounting to the equity method of accounting, or from the equity method to another basis of accounting, would be accounted for prospectively. See CG 4.7 for a further discussion of changes in interest on equity method investments.

When a reporting entity already consolidates an investee, changes that do not result in losing control are recorded as equity transactions, irrespective of whether the subsidiary is a VIE or voting interest entity, as illustrated in Example 1-2.

**EXAMPLE 1-2**

*Change in ownership interest of a VIE*

Parent became the primary beneficiary of a VIE (Entity A) on October 1, 20X0. Parent initially consolidated Entity A by recognizing the fair value of Entity A’s assets, liabilities, and noncontrolling interests as of the date it became the primary beneficiary. The noncontrolling interest was in the form of common stock.

On March 2, 20X1, Parent acquires the remaining common shares of Entity A and becomes the 100% owner of the common stock of Entity A.
How does Parent record the acquisition of the common shares held by Entity A’s noncontrolling interest holders?

Analysis

As Parent already had control, the acquisition of the noncontrolling interest should be reflected as an equity transaction in accordance with ASC 810-10-45-23. Any difference between the amount paid and the carrying amount of the noncontrolling interest should be recorded directly in Parent’s equity.

When control of an entity transfers and is considered to be a transfer of net assets between entities under common control, the receiving entity reflects a change in the reporting entity on a retrospective basis. ASC 805-50-30-5 applies to transfers of net assets between entities under common control and requires the receiving entity to reflect the transfer in a manner similar to a pooling of interests. The prior period financial statements would be restated to reflect the consolidation as of the date the transferor and the receiving entity came under common control. 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 earliest reporting period presented. However, note that the transferring entity’s accounting would differ. See BCG 7.2.3.2 for further discussion on the accounting for changes in a reporting entity.

As noted in the following extract, in some cases there could be a difference between the carrying amounts of the assets and liabilities reflected in the consolidated parent’s books and the carrying amounts in the books of the contributing entity. The receiving entity should record the assets based on the parent’s basis and not that of the contributing entity. See BCG 7.2.3 for further discussion on the accounting by the receiving entity and BCG 7.2.4 for further discussion on the accounting by the contributing entity.

ASC 805-50-30-5

When accounting for a transfer of assets or exchange of shares between entities under common control, the entity that receives the net assets or the equity interests shall initially measure the recognized assets and liabilities transferred at their carrying amounts in the accounts of the transferring entity at the date of transfer. If the carrying amounts of the assets and liabilities transferred differ from the historical cost of the parent of the entities under common control, for example, because pushdown accounting had not been applied, then the financial statements of the receiving entity shall reflect the transferred assets and liabilities at the historical cost of the parent of the entities under common control.

1.5.2.1 Initial consolidation

When a reporting entity obtains control of a legal entity, it must determine if the net assets within the legal entity constitute a business. To the extent it is a business, acquisition accounting procedures under ASC 805 would be applied irrespective of whether control is gained under the VIE or voting interest entity model. Therefore, the initial consolidation of a VIE that is a business and not received in a common control transaction is treated as a business combination. See BCG 1 for the definition of a business and BCG 2 for application of the acquisition method when acquiring a business.
If a reporting entity obtained control of a legal entity that is not a business and not a common control transfer, then it is accounted for as an asset acquisition. See PPE 2 for details on the accounting for acquisitions that do not constitute a business. However, if the legal entity is a VIE, the reporting entity (primary beneficiary) should account for the initial consolidation pursuant to the guidance in ASC 810-10-30-4. A gain or loss may be recognized if the variable interest entity is not a business. See CG 2.5 for more information.

In limited circumstances, a reporting entity that is determined to be the primary beneficiary of a VIE does not have an equity investment in the entity. In these cases, the primary beneficiary must consolidate 100% of the balance sheet and income statement of the VIE and should generally apply consolidation procedures as if it were the parent in a typical parent-subsidiary relationship. These consolidation procedures include applying the acquisition method if the VIE is a business, and reflecting equity interests in the VIE held by other parties as a noncontrolling interest.

### 1.5.2.2 Loss of control (consolidation)

A reporting entity can lose control of a subsidiary for a number of reasons, including the circumstances discussed below.

<table>
<thead>
<tr>
<th>ASC 810-10-55-4A</th>
</tr>
</thead>
<tbody>
<tr>
<td>All of the following are circumstances that result in deconsolidation of a subsidiary under paragraph 810-10-40-4:</td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td>b. The expiration of a contractual agreement that gave control of the subsidiary to the parent.</td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td>d. The subsidiary becomes subject to the control of a government, court, administrator, or regulator.</td>
</tr>
</tbody>
</table>

Refer to BCG 5.5 for additional guidance with respect to deconsolidation following a loss of control. The reporting entity should also consider the applicability of the presentation and disclosure requirements for discontinued operations, as further discussed in FSP 27.
### 1.5.2.3 Summary of changes in interest transactions (consolidation)

The following table summarizes the accounting for changes in interest.

**Figure 1-5**

Overview of changes in interest

<table>
<thead>
<tr>
<th>Change in interest</th>
<th>Accounting result</th>
<th>Impact to investor’s financial statements</th>
<th>Discussed in</th>
</tr>
</thead>
<tbody>
<tr>
<td>No existing investment. Acquisition of less than 100% of business acquired (partial acquisition)</td>
<td>Gain control</td>
<td>Recognize 100% of identifiable assets and liabilities</td>
<td>BCG 5</td>
</tr>
<tr>
<td></td>
<td>Consolidate as of the date control is obtained</td>
<td>Recognize the NCI in equity</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Recognize the NCI in equity</td>
<td>Recognize 100% of goodwill</td>
<td></td>
</tr>
<tr>
<td>Fair value (or measurement alternative) to consolidation of a business (step acquisition)</td>
<td>Gain control</td>
<td>Recognize 100% of identifiable assets and liabilities</td>
<td>BCG 5</td>
</tr>
<tr>
<td></td>
<td>Eliminate previously held equity interest and consolidate as of the date control is obtained</td>
<td>Remeasure the previously held equity interest to fair value and recognize any difference between fair value and carrying value, if any, as a gain or loss in net income</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Recognize a gain or loss, if any, on a previously held equity interest in the income statement</td>
<td>Recognize 100% of goodwill</td>
<td></td>
</tr>
<tr>
<td></td>
<td>If less than 100% acquired, recognize the NCI in equity</td>
<td>If less than 100% interest is acquired:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>□ Recognize the NCI at fair value</td>
<td>□ Recognize 100% of goodwill or bargain purchase gain</td>
<td></td>
</tr>
<tr>
<td>Equity method to consolidation</td>
<td>Gain control</td>
<td>Remeasure the previously held equity method investment to fair value and recognize any difference between fair value and carrying value in net income</td>
<td>BCG 5</td>
</tr>
<tr>
<td></td>
<td>Cease applying equity method and eliminate previously held equity interest; consolidate as of the date control is obtained</td>
<td>Recognize 100% of identifiable assets and liabilities</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Recognize the NCI in equity if less than 100% obtained</td>
<td>□ Recognize the NCI, if any, at fair value</td>
<td></td>
</tr>
<tr>
<td></td>
<td>□ Recognize 100% of goodwill or bargain purchase gain</td>
<td>□ Recognize 100% of goodwill or bargain purchase gain</td>
<td></td>
</tr>
<tr>
<td>Consolidation to consolidation (acquisition)</td>
<td>Change of interest</td>
<td>Do not recognize a gain or loss in the income statement</td>
<td>BCG 5</td>
</tr>
<tr>
<td></td>
<td>Account for as an equity transaction</td>
<td>Recognize the difference between the fair value of the consideration paid and the related carrying value of the NCI acquired in the controlling entity’s equity</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Reclassify the carrying value of the NCI obtained from the NCI to the controlling entity’s equity</td>
<td></td>
</tr>
<tr>
<td>Consolidation to consolidation (sale)</td>
<td>Change of interest</td>
<td>Do not recognize a gain or loss in the income statement</td>
<td>BCG 5</td>
</tr>
<tr>
<td></td>
<td>Account for as an equity transaction</td>
<td>Recognize the difference between the fair value of the consideration received and the related carrying value of the controlling interest sold in the</td>
<td></td>
</tr>
<tr>
<td>Change in interest</td>
<td>Accounting result</td>
<td>Impact to investor’s financial statements</td>
<td>Discussed in</td>
</tr>
<tr>
<td>--------------------------------------------------------</td>
<td>------------------------------------------------------</td>
<td>--------------------------------------------------------</td>
<td>--------------</td>
</tr>
<tr>
<td>Fair value (or measurement alternative) to equity method</td>
<td>Significant influence (control not obtained)</td>
<td>May elect the fair value option</td>
<td>CG 4.4 (and CG 4.4.5)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Assuming the fair value option is not elected:</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>□ Determine basis differences for entire investment</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>□ Recognize investment at investor’s current basis of previously held interests plus cost of incremental investment, if any.</td>
<td></td>
</tr>
<tr>
<td>Consolidation to equity method</td>
<td>Loss of control but obtain/retain significant influence – due to sale or dilution of interest</td>
<td>Cease consolidation accounting from the date control is lost. Apply equity method prospectively (not a change in accounting principle); may elect the fair value option</td>
<td>CG 4.4</td>
</tr>
<tr>
<td></td>
<td></td>
<td>The same accounting guidance applies to the loss of control of a subsidiary that is a VIE or voting interest entity</td>
<td></td>
</tr>
<tr>
<td>Equity method to equity method (acquisition)</td>
<td>Continue to have significant influence – common stock and/or “in substance” common stock acquired</td>
<td>Continue to apply equity method (assuming fair value option not previously elected)</td>
<td>CG 4.7.5</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Recognize cost for incremental investment (cost accumulation), determine basis differences arising on acquisition of new “step” interest using fair values of underlying investee assets and liabilities on the acquisition date</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Prospectively recognize investor’s share of equity investee’s earnings based on new ownership interest, adjusted for the effects of new and previous basis differences, and other items (see CG 4.4.5)</td>
<td></td>
</tr>
<tr>
<td>Equity method to equity method (sale)</td>
<td>Continue to have significant influence – common stock and/or “in substance” common stock sold directly or through a dilution transaction²</td>
<td>Continue to apply equity method (assuming the fair value option was not previously elected)</td>
<td>CG 4.7.5</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Recognize gain or loss to the extent that the proceeds from the sale exceed or are less than the investor’s decrease in ownership interest in the underlying investee net assets plus the proportionate share of the unamortized balance of any basis differences</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Prospectively recognize investor’s share of equity investee’s earnings based on new interest, adjusted for the effects of basis differences, and other items (see CG 4.4.5)</td>
<td></td>
</tr>
</tbody>
</table>

1. Change in interest
2. Accounting result
3. Impact to investor’s financial statements
4. Discussed in

- Significant influence
- May elect the fair value option
- Assumption: fair value option is not elected:
  - Determine basis differences for entire investment
  - Recognize investment at investor’s current basis of previously held interests plus cost of incremental investment, if any.

- CG 4.4
- CG 4.4 (and CG 4.4.5)

- Loss of control but obtain/retain significant influence – due to sale or dilution of interest
- Cease consolidation accounting from the date control is lost. Apply equity method prospectively (not a change in accounting principle); may elect the fair value option
- The same accounting guidance applies to the loss of control of a subsidiary that is a VIE or voting interest entity

- CG 4.4

- Continue to have significant influence – common stock and/or “in substance” common stock acquired
- Continue to apply equity method (assuming fair value option not previously elected)
- Recognize cost for incremental investment (cost accumulation), determine basis differences arising on acquisition of new “step” interest using fair values of underlying investee assets and liabilities on the acquisition date
- Prospectively recognize investor’s share of equity investee’s earnings based on new ownership interest, adjusted for the effects of new and previous basis differences, and other items (see CG 4.4.5)

- CG 4.7.5

- Continue to have significant influence – common stock and/or “in substance” common stock sold directly or through a dilution transaction²
- Continue to apply equity method (assuming the fair value option was not previously elected)
- Recognize gain or loss to the extent that the proceeds from the sale exceed or are less than the investor’s decrease in ownership interest in the underlying investee net assets plus the proportionate share of the unamortized balance of any basis differences
- Prospectively recognize investor’s share of equity investee’s earnings based on new interest, adjusted for the effects of basis differences, and other items (see CG 4.4.5)

- CG 4.7.5
### Change in interest

<table>
<thead>
<tr>
<th>Consolidation to fair value (or measurement alternative) or no retained interest</th>
<th>Accounting result</th>
<th>Impact to investor’s financial statements</th>
<th>Discussed in</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loss of control, and no longer hold significant influence</td>
<td>Change classification and measurement of investment</td>
<td>Deconsolidate investment</td>
<td>BCG 5</td>
</tr>
<tr>
<td></td>
<td>Cease consolidation accounting and begin accounting for investment under other applicable guidance</td>
<td>Remeasure any retained noncontrolling investment at fair value</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Recognize gain or loss on disposal and gain or loss on the retained noncontrolling investment in the income statement</td>
<td>Recognize gain or loss on interest sold and gain or loss on the retained noncontrolling investment in the income statement</td>
<td></td>
</tr>
<tr>
<td></td>
<td>The same accounting guidance applies to the loss of control of a subsidiary that is a VIE or voting interest entity</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Equity method to fair value (or measurement alternative) or no retained investment</strong></td>
<td>Lose significant influence - common stock and/or &quot;in-substance&quot; common stock sold or through a dilution transaction²</td>
<td>Cease applying equity method; apply other accounting to any retained interest</td>
<td>CG 4.7.2</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Recognize gain or loss to the extent that the proceeds from the sale exceed or are less than the investor’s ownership interest in the underlying investee net assets sold plus the proportionate share of the unamortized balance of any basis differences. The investor’s initial carrying amount of any retained common stock or &quot;in-substance&quot; common stock investment would include the proportionate share of previously recognized earnings or losses of the investee.</td>
<td></td>
</tr>
</tbody>
</table>

1 For equity securities without readily determinable fair value, ASC 321 allows measurement at cost minus impairment, if any, plus or minus changes resulting from observable price changes.

2 Note that in some cases, an investor’s equity investment may in effect be diluted in an exchange transaction where, in other cases, an investor’s equity investment may be exchanged for another equity method investment. See CG 4.4.1.5 for further discussion.

### 1.5.3 Intercompany eliminations in consolidation

The intercompany eliminations process for consolidated subsidiaries is discussed in CG 6.2. A consistent approach is followed for consolidated VIEs and voting interest entities, with one key exception. When consolidating a VIE, the effect of eliminating any net intercompany profit or loss may not be allocated to the noncontrolling interest.

The process for eliminating intercompany transactions between an investor and an investee accounted for under the equity method is discussed in CG 4.5.2. Intercompany profit generally should be eliminated to the extent of the investor’s interest in the investee in situations where the investor sells assets to an equity investee. The intercompany profit eliminated should be credited to the investment account.
1.5.4 **Allocation of comprehensive income to controlling and noncontrolling interests**

The guidance for the allocation of profits to noncontrolling interests does not distinguish between VIEs and voting interest entities consolidated by a reporting entity. No particular method is specified for attributing earnings between the controlling interest and the noncontrolling interest. If there is a contractual arrangement that determines the attribution of earnings, such as a profit-sharing agreement, the attribution specified by the arrangement should be considered if it is determined to be substantive (see CG 4.5.1 for discussion of profit or loss allocation in these situations). If there is not a contractual arrangement, then the relative ownership interest generally should be used as the basis for attribution of earnings between controlling and noncontrolling interests.

Since the same principles are applied to a consolidated VIE, a parent (the primary beneficiary) should show a negative noncontrolling interest position (debit balance) related to a consolidated VIE if the subsidiary generates losses that would cause the noncontrolling interest balance to decrease below zero. That is, losses should continue to be attributed to the noncontrolling interest even if that attribution results in a deficit noncontrolling interest balance.

**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.

It is common for some of the equity holders of a VIE to also be employees of the primary beneficiary. Depending on the facts and circumstances, such distributions may be compensatory (therefore requiring expense recognition) or, may be 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:

- Appropriate value was received by the VIE in exchange for the distribution (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 commensurate 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

See BCG 6.4.1 for a discussion of the allocation of net income and comprehensive income between the controlling and noncontrolling interests.
Chapter 2:
Variable interest entity model
2.1 Scope of consolidation guidance

Most entities are required to be evaluated under the provisions of ASC 810-10 to determine whether they have the attributes of a VIE. ASC 810-10 exempts certain legal entities from consolidation under the VIE model, but these exceptions are relatively few.

In addition, specified legal entities (e.g., not-for-profit entities and certain businesses) are excluded only from the VIE consolidation evaluation. These entities would still need to be evaluated for potential consolidation under the voting interest consolidation model discussed in CG 3.

2.1.1 Consolidation background and general considerations

Absent a scope exception, any legal entity—regardless of its legal form and the scope of its activities—may be subject to consolidation under the VIE model. The ASC Master Glossary provides the following definition of a legal entity.

**Definition from ASC 810-10-20**

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.

As discussed in CG 1.2.2, the definition of legal entity is expansive. The term is intended to encompass all legal structures established to manage or administer activities of any kind, or to hold assets or incur liabilities. CG 1.2.2.1 cites various factors that may be relevant when evaluating whether a particular structure is, in fact, a legal entity.

2.1.1.1 “Virtual” SPEs or portions of legal entities

ASC 810-10-15-15 affirms that “virtual SPEs” (divisions, departments, branches, or pools of assets subject to liabilities that are otherwise nonrecourse to other assets of the broader entity) are not considered separate entities for purposes of applying the VIE model. However, if the overarching legal entity is deemed a VIE, there are circumstances in which a virtual SPE or “silo” may be consolidated as if it were a stand-alone entity. Silos are discussed in more detail in CG 2.2.8.

2.1.1.2 Consolidation of majority-owned or wholly-owned subsidiaries

ASC 810-10-15-15 also clarifies that a wholly- or majority-owned subsidiary (that is, a legal entity separate from its parent) is subject to the VIE model and may be a VIE. If the subsidiary is a VIE, a reporting entity other than the subsidiary’s legal parent may be required to consolidate it under the VIE model. In this case, the subsidiary’s legal parent would not consolidate the subsidiary and instead would likely report its interest as a one-line investment on its balance sheet.

Example 2-1 illustrates when a legal parent may not be required to consolidate a subsidiary.
EXAMPLE 2-1

Majority-owned subsidiaries: VIE assessment

Reporting Entity A holds all of the voting shares of Entity XYZ and has previously consolidated Entity XYZ under the voting interest entity model. During the current reporting period, Entity XYZ enters into a contractual arrangement with Reporting Entity B that conveys to Reporting Entity B certain decision making rights with respect to, and an entitlement to economic returns from, Entity XYZ. Reporting Entity B holds no equity investment in Entity XYZ.

What are the potential consolidation implications for Reporting Entity A and Reporting Entity B stemming from the new contractual arrangement?

Analysis

Since subsidiaries are not exempt from the VIE model, Reporting Entity A, Reporting Entity B, and other parties that hold variable interests in Entity XYZ must determine whether Entity XYZ is a VIE. Upon executing their contractual arrangement, Reporting Entity A and Reporting Entity B each must evaluate whether it should consolidate Entity XYZ. It is possible that Reporting Entity B could be required to consolidate Entity XYZ, notwithstanding that it owns no equity investment in Entity XYZ.

2.1.2 Scope exceptions to the VIE model

ASC 810-10-15 enumerates a limited number of circumstances when a reporting entity is not required to apply the VIE model to a legal entity in which it has an interest. That paragraph also cites a handful of other exceptions to the VIE model outlined in ASC 810-10-15-12.

Although certain of the scope exceptions discussed below appear straightforward, their application may require thoughtful judgment and consideration of the circumstances. Moreover, the reporting entity must continually reassess whether a scope exception deemed to have been met when it first became involved with the legal entity continues to be satisfied.

2.1.2.1 VIE scope exception — not-for-profit organizations

This scope exception applies to all reporting entities subject to the consolidation requirements in ASC 958, Not-for-Profit Entities—Consolidation (ASC 958).

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 in the Variable Interest Entities Subsections, that NFP shall be subject to the guidance in the Variable Interest Entities Subsections.

The exception also applies to NFP health care organizations subject to the AICPA 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
Variable interest entity model

- A for-profit reporting entity does not have to apply the VIE model to an 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 an NFP entity should apply the VIE model to determine whether the NFP is a VIE and, if so, conclude whether the reporting entity is the NFP’s primary beneficiary.

Based on the guidance in ASC 810-10-25-43, an NFP may be a related party of a for-profit reporting entity. If so, when evaluating whether the for-profit reporting entity is the primary beneficiary of a for-profit VIE, the reporting entity must consider the involvement of the related party NFP, including any variable interest in the VIE or any power over the VIE’s significant activities held by the related party NFP.

2.1.2.2 VIE scope exception — life insurance entities

Separate accounts of life insurance entities are not subject to consolidation by another reporting entity under the VIE model. ASC 944-80, Financial Services—Insurance, Separate Accounts, prescribes that separate account assets and liabilities should be included in the financial statements of the insurer that owns the assets and is contractually obligated to pay the liabilities.

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.

Separate account arrangements are considered to be separate investment entities and, as such, may have separate reporting requirements. For purposes of the stand-alone reporting requirements, separate account arrangements governed by SEC Regulation S-X, Rule 6-03(c)(1) are eligible for the same scope exception from ASC 810 as other registered investment companies, as discussed in CG 1.2.3.2. That discussion is also relevant for non-registered separate accounts subject to the AICPA Audit and Accounting Guide, Investment Companies.

ASC 944-80-25-3(d) clarifies that a separate account’s specialized accounting for investments is to be retained in the financial statements of the sponsoring insurer. That is, an insurance entity does not consolidate an investment in which a separate account has a controlling financial interest if the investment is not required to be consolidated in the stand-alone financial statements of the separate account.

Note that the scope exception for separate accounts does not extend to investments held by an insurer’s general account. An insurer must consider the consolidation implications for any investments held by its general account based on the relevant guidance in ASC 810. Further, as directed by ASC 944-80-25-3(f), separate account interests held for the benefit of a related party policyholder are to be combined with the insurer’s general account interest when the VIE analysis requires consideration of related parties.

2.1.2.3 VIE scope exception — “information-out”

When FIN 46R was issued, the FASB recognized that there may have been instances where reporting entities entered into arrangements prior to December 31, 2003 that, for a variety of reasons, did not permit them to obtain the information necessary to apply the VIE model.
**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 do any one of the following:

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

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

As the excerpt states, these instances were expected to be infrequent, especially if the reporting entity was involved in the design of the entity or if the reporting entity was exposed to substantial risks of the entity.

We have noted very few reporting entities disclosing this exception in their financial statements. Considering the amount of time that has elapsed since FIN 46R’s release in 2003, we expect it to be rare and unusual for a reporting entity to invoke this exception.

**2.1.2.4 VIE scope exception — business scope exception**

Determining whether the VIE model applies to an entity that meets the definition of a business can be one of the more challenging aspects of ASC 810. The VIE model provides the following scope exception (the “business scope exception”) for reporting entities having a variable interest(s) in a business entity.

**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.

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

The VIE model addresses situations where the voting interest entity approach may not identify the party having a controlling financial interest in an entity. When deliberating FIN 46R, the Board considered, but ultimately opposed, providing a scope exception for all businesses, believing that such a distinction was contrary to the principle underlying the VIE model. Therefore, ASC 810-10-15-17(d) is not intended to provide a scope exception to all businesses.

The business scope exception allows reporting entities to avoid applying the VIE model in circumstances where it is unlikely that the reporting entity would be required to consolidate a business (as the primary beneficiary), even if the entity is a VIE. The Board concluded that the most useful way to provide this implementation relief would be through a targeted scope exception consisting of a series of conditions that, if met, would obviate the need for further analysis under the VIE model.

The criteria in the business scope exception focus on the relationships between the reporting entity and the legal entity. Whether the entity has the characteristics of a VIE, as specified in ASC 810-10-15-14, is not relevant. Each reporting entity with an interest in the entity is required to evaluate its relationships with the entity. The fact that one reporting entity concludes that the legal entity being evaluated is eligible for the business scope exception does not provide the basis for another reporting entity to conclude similarly. In fact, one reporting entity may conclude that the entity meets the business scope exception, while another reporting entity involved with the same entity may not, and may conclude that the entity is a VIE.

Although the application of the business scope exception may seem straightforward, it is not. The analysis involves evaluating several factors in addition to the specific facts and circumstances of the transaction. The first step is to determine whether the entity is a business. The second step is to determine whether or not any of the four conditions cited in ASC 810-10-15-17(d) are met. If any of the four conditions is present, the reporting entity is precluded from utilizing the scope exception. If a reporting entity concludes that the business scope exception is met, the reporting entity should evaluate whether the exception remains satisfied at each subsequent reporting period.

Each condition in ASC 810-10-15-17(d) that is required to apply or precludes applying the business scope exception is detailed below.
**What is a business?**

To apply the business scope exception, the reporting entity must determine whether or not the entity is a business. In January 2017, the FASB issued Accounting Standards Update 2017-01, *Clarifying the Definition of a Business*. The changes to the definition of a business will likely result in more transactions being accounted for as asset acquisitions rather than business combinations across most industries.

For public business entities, ASU 2017-01 was effective for financial statements issued for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. For all other entities, the guidance is effective for financial statements issued for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption is permitted, including adoption in an interim period. Prospective application is required.

*Before adoption of ASU 2017-01: Clarifying the Definition of a Business*

The definition of a business appears in the ASC Master Glossary.

**Definition from ASC Master Glossary**

Business: An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants. Additional guidance on what a business consists of is presented in paragraphs 805-10-55-4 through 55-9.

ASC 805-10-55-4 defines inputs, processes, and outputs as follows. Additional guidance for evaluating these elements of a business can be found in ASC 805-10-55-5 through ASC 805-10-55-9.

**ASC 805-10-55-4**

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

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

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

1. 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.

After adoption of ASU 2017-01: Clarifying the Definition of a Business

ASU 2017-01 created a new framework for entities to use in evaluating whether an integrated set of assets and activities (collectively a “set”) should be accounted for as a business or a group of assets. It added an initial screen to determine if substantially all of the fair value of the gross assets is concentrated in a single asset or group of similar assets. If that screen is met, the set is not a business. Refer to BCG 1.2.1 for guidance on the screen test. The new framework also specifies the minimum required inputs and processes necessary to be a business and removes the need to consider a market participant’s ability to replace missing elements. ASC 805-10-55-3A defines a business.

Excerpt from ASC 805-10-55-3A

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.

In order to be a business, a set needs to have an input and a substantive process that together significantly contribute to the ability to create outputs. The guidance provides a framework to evaluate when an input and a substantive process are present (including for early stage companies that have not generated outputs). It includes more stringent criteria for sets without outputs to be considered businesses. The new guidance narrows the definition of “outputs” to be consistent with how it is described in ASC 606, Revenue from Contracts with Customers. For additional details on what is considered an output, refer to RR 1.2. For guidance on evaluating the framework when outputs are or are not present, refer to BCG 1.2.2.1 and BCG 1.2.2.2.

Assuming that a reporting entity concludes that the entity in question is a business, it may invoke the business scope exception, provided that none of the following conditions are met:

Condition 1: design of the entity

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.

ASC 810-10-15-17(d)(1) is a condition that requires an understanding of the dynamics behind the entity’s design or redesign (the “design of the entity” condition). Indicators that the reporting entity was involved in the design (or redesign) of the entity include participating in the establishment of:

- capital structure,
square governance structure, or
square operating activities.

In connection with this analysis, the reporting entity must determine whether its related parties participated in these activities. If so, the scope exception may not be available. As described in the exception, for purposes of evaluating the design of the entity condition, related parties include certain de facto agents.

If an entity undergoes a redesign or restructuring, the reporting entity must re-evaluate this condition, taking into account the nature and extent of its involvement, if any, with those changes.

There are two instances when involvement in the design of the entity does not preclude a reporting entity from applying the business scope exception:

square Operating joint ventures under joint control of the reporting entity and one or more unrelated parties

To qualify for this exception, the entity must meet the definition of a joint venture as defined in the ASC Master Glossary.

**Definition from ASC Master Glossary**

Joint Venture: An entity owned and operated by a small group of businesses (the joint venturers) as a separate and specific business or project for the mutual benefit of the members of the group. A government may also be a member of the group. The purpose of a 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 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 joint venture. The ownership of a joint venture seldom changes, and its equity interests usually are not traded publicly. A minority public ownership, however, does not preclude an entity from being a joint venture. As distinguished from a corporate joint venture, a joint venture is not limited to corporate entities.

An operating joint venture must comply with the remaining conditions in ASC 810-10-15-17(d) to qualify for the business scope exception. Refer to CG 5 for further discussion on operating joint ventures.

square Franchisees

Absent this carve-out, all franchisee entities, as defined in the ASC Master Glossary, would meet the design of the entity condition, and because the condition was present, would be precluded from applying the business scope exception. However, the FASB does not believe that all entities holding franchise agreements are, by definition, VIEs. Therefore, to alleviate the burden of applying the VIE model to franchisees, the Board decided that the design of the entity condition does not apply to an entity that is a franchisee.
Franchisee entities must comply with the remaining conditions in ASC 810-10-15-17(d) to qualify for the business scope exception.

**Condition 2: the “substantially all” test**

**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.

Entities having a narrow business purpose intended to complement the reporting entity’s operating or financing activities meet the substantially all test. Most questions regarding this condition involve the appropriate interpretation of the phrase “substantially all of its activities either involve or are conducted on behalf of.” This phrase is also used to characterize entities established with non-substantive voting rights (see ASC 810-10-15-14(c)), and thus we believe that this condition should be interpreted and applied in a consistent manner.

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% or more of the economics of the entity relate or accrue to the benefit of a particular party. 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.

Figure 2-1 lists indicators that may assist in the evaluation of whether the substantially all criterion has been met.

**Figure 2-1**

Indicators of whether the substantially all criterion have been met

<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 <strong>substantially all</strong> of its products to the reporting entity under long-term contracts.</td>
<td>□ The entity’s major activities include selling a <strong>majority</strong> of its products to the reporting entity, and these arrangements are expected to continue either because of long-term contracts or for other reasons.</td>
</tr>
<tr>
<td>□ The entity’s major activities include purchasing <strong>substantially all</strong> of its purchased products from the reporting entity.</td>
<td>□ The entity’s major activities include purchasing a <strong>majority</strong> of its purchased products from the reporting entity.</td>
</tr>
<tr>
<td>Strong indicators</td>
<td>Other indicators</td>
</tr>
<tr>
<td>-------------------</td>
<td>------------------</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, 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>
<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 substantially all 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 majority of the entity’s activities.</td>
</tr>
<tr>
<td>□ The reporting entity has outsourced operations to the entity, constituting substantially all of the entity’s activities.</td>
<td>□ The reporting entity has outsourced to the entity operations that constitute a majority of the entity’s activities.</td>
</tr>
<tr>
<td>□ Substantially all of the entity’s assets are leased to the reporting entity.</td>
<td>□ A majority 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 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% 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%) toward the reporting entity.</td>
</tr>
</tbody>
</table>

1With respect to evaluating these indicators, the term “reporting entity” includes the reporting entity’s related parties (as defined in ASC 810-10-25-43).

There are no broad “rules of thumb” or “bright lines” to shortcut the evaluation of the substantially all condition. Instead, reporting entities should assess all facts and circumstances; judgment is required. Absent mitigating factors (i.e., indicators that point to a different conclusion), 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. If the reporting entity meets several of the “Other indicators,” evaluating whether the substantially all condition has been met warrants careful consideration.

To protect the brand, franchise agreements between a franchisor and a franchisee often incorporate unique terms and provisions. As a result, these agreements should be analyzed carefully. Figure 2-1 above should prove useful when evaluating whether a franchise arrangement is designed such that substantially all of the franchisee’s 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 franchisee), as well as other indicators, some of which are described in more detail in ASC 952, Franchisors, specifically in ASC 952-810-55-2.

**Condition 3: subordinated financial support**

**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.

Determining whether the reporting entity and its related parties provide more than half of the financial support to the entity requires consideration of two defined terms from the ASC Master Glossary:

**Definitions from ASC Master Glossary**

Subordinated Financial Support: Variable interests that will absorb some or all of a variable interest entity’s (VIE’s) expected losses.

Expected Losses (excerpt): 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 of variability of the net income or loss.

When evaluating this condition, a reporting entity should consider all variable interests that it 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. It may not be easy to inventory such interests, and related fair-value information is often not available. Therefore, this assessment may be difficult to undertake in practice, particularly in situations where the reporting entity’s financial support to the entity is substantial (and/or takes various forms).

As a practical matter, the business scope exception will generally be available only when it is obvious that the reporting entity will not absorb the majority of the economics of the entity on a fair value basis. For certain arrangements – for example, a 50:50 joint venture – it may be difficult to make this assertion. In a 50:50 venture, although the entity’s economics are intended to be equally shared, that may not be the case when viewed more broadly. There may be other commercial arrangements between the owners and the venture that constitute variable interests, such as in the form of management contracts and the like. In these instances, absent a comprehensive analysis, it may be difficult to demonstrate that the reporting entity does not hold a majority of the economic interests in
the venture. Therefore, in these circumstances, it is more likely than not that the entity will warrant evaluation under the VIE model.

**Condition 4: common financing structures**

**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 of the four conditions. This criterion is intended to ensure that entities considered “typical” SPE structures – trusts that securitize receivables, issuers of collateralized loan obligations and the like – are assessed under the VIE model.

In applying this condition, we believe that the phrase “single-lessee leasing arrangements” should be interpreted broadly. That is, we believe the term includes entities that have entered into long-term supply arrangements containing an embedded lease under ASC 840-10-15-6 (or ASC 842-10-15-3, once ASC 842 is effective). In fact patterns where an entity is deemed to be a single-lessee leasing arrangement, the reporting entity would not be eligible for the business scope exception.

**2.1.2.5 VIE scope exception — private company exception**

A reporting entity that is a private company is not required to apply VIE guidance to lessor entities under common control if certain criteria are met. ASU 2018-17, Targeted Improvements to Related Party Guidance for Variable Interest Entities, issued in October 2018, expands the private company accounting alternative beyond common control lease arrangements.

The amendments in ASU 2018-07, including the changes made regarding indirect interests held by decision makers, are effective for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. The amendments are effective for a private company for fiscal years beginning after December 15, 2020. All entities are required to apply the amendments retrospectively with a cumulative-effect adjustment to retained earnings at the beginning of the earliest period presented. Early adoption is permitted, including adoption in an interim period.

**Private company exception — before adoption of ASU 2018-17**

ASC 810-10-15-17AB exempts private company lessees from applying the VIE model to lessor entities if certain conditions are met. This exception is an accounting policy election that should be applied by a private company to all entities that meet the criteria. A private company lessee that chooses to make this election still must apply other consolidation guidance in ASC 810 to the lessor entity as applicable.

**ASC 810-10-15-17AB**

A legal entity need not be evaluated by a private company under the guidance in the Variable Interest Entities Subsections if criteria (a) through (c) are met and, in applicable circumstances, criterion (d) is met:
a. The private company lessee (the reporting entity) and the lessor legal entity are under common control.

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

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

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

See paragraph 810-10-55-9 and paragraphs 810-10-55-205AJ through 55-205AR for implementation guidance.

The first three criteria need to be reassessed at each reporting date. The last criterion is only required to be assessed at inception of the guarantee or collateral arrangement or when those contracts are amended. If any of the criteria are no longer met, the private company is required to apply the VIE guidance on a prospective basis, as of the date that the arrangement no longer qualifies for the alternative. For example, if the owner sells all of its equity interest in the lessor, the common control criterion would not be met and the lessee would need to apply the VIE model from the sale date to determine whether consolidation of the lessor is required.

See FSP 18.9 for information on necessary disclosures.

**Private company exception — after adoption of ASU 2018-17**

The amendments in ASU 2018-17, issued in October 2018, expand the private company accounting alternative beyond common control lease arrangements. Under the new ASU, a reporting entity that is a private company is not required to apply VIE guidance to legal entities under common control (including common control leasing arrangements) if both the parent and the legal entity being evaluated for consolidation are not public business entities.

The accounting alternative is an accounting policy election that a private company should apply to all current and future legal entities under common control that meet the below criteria. In other words, the alternative cannot be applied to some common control arrangements and not to others. If the alternative is elected, a private company will continue to apply other consolidation guidance in ASC 810, as applicable.

**810-10-15-17AD**

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

a. The reporting entity and the legal entity are under common control.

b. The reporting entity and the legal entity are not under common control of a public business entity.

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

See CG 2.2.4.2 for information about assessing whether common control exists. To determine if the private company (reporting entity) and the legal entity are under common control of a parent solely for the purpose of applying ASC 810-10-15-17AD(a), reporting entities would only consider a parent’s direct and indirect voting interests in the private company and the legal entity. In other words, the guidance in the Variable Interest Entities Subsections of ASC 810 is not applied when making this determination. See ASC 810-10-55-205AV through ASC 810-10-55-205AZ for illustrative examples on determining whether common control exists solely for purposes of applying the accounting alternative, and ASC 810-10-55-205BA through ASC 810-10-55-205BF for illustrative examples on the application of the alternative.

If a reporting entity meets the criteria for the exemption and then at a future date any of the criteria cease to be met, a private company will apply VIE guidance at the date of change on a prospective basis, except for situations in which a reporting entity becomes a public business entity. If the reporting entity becomes a public business entity, the entity would apply the VIE guidance in accordance with ASC 250 on accounting changes.

A private company is required to provide detailed disclosures about its involvement with and exposure to a legal entity under common control, as specified in ASC 810-10-50-2AG through ASC 810-10-50-2AI, unless the legal entity is consolidated by the reporting entity through accounting guidance other than VIE guidance.

Refer to FSP 18.9 for more information on the necessary disclosures.

## 2.2 Variable interests

A reporting entity must first determine whether it holds a “variable interest” in an entity to be evaluated for potential consolidation under ASC 810. If a reporting entity concludes that it holds a variable interest in an entity, it must evaluate whether that entity is a VIE. That assessment, in turn, will dictate which of the two consolidation models – the VIE model or the voting interest model – applies to the entity in question.

Variable interests can take many forms, including equity and debt investments, guarantees, derivatives, management contracts, service contracts, and leases. In many instances, concluding whether an instrument or contract is a variable interest may require only a cursory analysis. In other cases, however, the evaluation may not be as straightforward. Moreover, variable interests can exist in implicit relationships, especially if related party relationships are involved. For example, an implicit variable interest may exist if a reporting entity can be compelled to protect a related party entity from making losses or to make funds available to that entity.

### 2.2.1 What is a “variable interest”?

ASC 810-10-20 defines the term variable interest as follows.
Excerpt from ASC 810-10-20

Variable Interests: The investments or other interests that will absorb portions of a variable interest entity’s (VIE’s) expected losses or receive portions of the entity’s expected residual returns are called variable interests. Variable interests in a VIE are contractual, ownership, or other pecuniary interests in a VIE that change with changes in the fair value of the VIE’s net assets exclusive of variable interests.

Expressed more simply, a variable interest is an economic arrangement that exposes or entitles a reporting entity to the economic risks and/or rewards of the entity—that is, the instrument or contract exposes its holder to an entity’s “variability.” ASC 810 frequently characterizes a variable interest as an interest that “absorbs” some or all of the variability that the entity was designed to create.

Not all instruments or contracts to which an entity is a party are its variable interests—certain of those instruments and contracts create or generate the variability that the entity intends to pass on to its variable interest holders. ASC 810-10-55-19 articulates this concept.

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

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

The “by design” approach serves as the framework for differentiating between an entity’s assets—that is, those items intended to “create” an entity’s variability—and its variable interests.

Example 2-2 and Example 2-3 demonstrate the identification of a variable interest.

EXAMPLE 2-2

Identifying variable interests

An entity’s primary activities involve the manufacture and sale of furniture. The entity purchases supplies and/or services from vendors, employees, and other parties to conduct its activities and create value in the business. The entity’s equity investors capitalize the entity at a level sufficient to achieve its business purpose.

Which party would absorb the variability of the entity?
Analysis

In this simple example, only the equity investors absorb the variability of the fair value of the entity’s net assets. The entity’s assets and other contractual arrangements create variability to 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 returns greater than expected) or negatively (i.e., when the activities generate returns less than expected).

EXAMPLE 2-3
Identifying variable interests

An entity’s primary activities involve the manufacture and sale of furniture. The entity purchases supplies and/or services from vendors, employees, and other parties to conduct its activities and create value in the business. The entity’s equity investors capitalize the entity at a level sufficient to achieve its business purpose.

The entity has decided to finance the acquisition of a new manufacturing facility through a subordinated loan from a third party bank.

Which parties hold a variable interest?

Analysis

The loan does not create variability in the value of the business – rather, the new manufacturing facility does, as the incremental cash inflows to the entity attributable to the facility will vary based on business conditions. As a creditor, the bank is exposed to the risks and uncertainties of the entity’s activities. 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.

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

Subsequent to the release of FIN 46R in 2003, diversity in practice developed in determining whether certain contracts should be considered creators of variability or, conversely, absorbers of variability (i.e., variable interests). Much of this diversity stemmed from different views regarding the role played by certain derivatives, particularly interest rate swaps and foreign currency derivatives. In determining whether these contracts (as well as certain cash instruments) were variable interests, some believed that only those items that absorbed variability resulting from changes in the entity’s cash flows (cash flow variability) should be considered variable interests, while others believed that those instruments that absorbed changes in the entity’s fair value (fair value variability) should also be considered variable interests. These different viewpoints fostered diversity in practice with respect to identifying the risks associated with an entity (i.e., the entity’s variability) and evaluating which party absorbed those risks.

The FASB staff responded to this diversity in practice by issuing guidance that indicates that, as the first step in its consolidation analysis, a reporting entity should carefully analyze an entity’s design. The goal of this analysis is to determine the variability that the entity was designed to create and distribute to its interest holders. This evaluation 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.
In many instances, it will be evident what variability an entity was designed to create and distribute to its interest holders. The analysis may not be so clear-cut in other cases. In any event, the “by design” model is intended to provide a framework that facilitates more consistent identification of an entity’s “variability” and thus, by extension, more consistent application of the VIE model. ASC 810-10-55-55 through ASC 810-10-55-86 provides eight examples that illustrate how to apply this guidance.

The “by design” model in ASC 810-10-25-22 through ASC 810-10-25-36 describes 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:

**ASC 810-10-25-22**

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

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

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

ASC 810-10-25-23 clarifies that, during this initial analysis, all instruments and contractual arrangements to which an entity is a party should be considered, and variability may be measured using methods that consider potential changes in cash flows and fair value of the entity.

**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.

**Step 1: identify the risks of the entity**

Step 1 of the “by design” model is generally a straightforward exercise – its objective is to identify all of the risks of the entity. ASC 810-10-25-24 cites the following examples of possible risks to which an entity may be subject.

**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.

**Step 2: identify the variability the entity was designed to create and pass along to its interest holders**

The purpose of Step 2 is to identify which of the risks identified in Step 1 create variability and thus 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, as outlined in ASC 810-10-25-25.

**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.

**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, an entity’s governing 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, taking into account the risks identified in Step 1.

To further assist financial statement preparers in making this determination, ASC 810-10-25-30 highlights a number of factors that should be considered when identifying the variability that the legal entity is designed to create and pass along to its interest holders. The considerations relate to the following:
Terms of the interests issued

Subordination of the interest

Certain interest rate risk

Certain derivative instruments

Each of these considerations is discussed below.

2.2.2.1 VIE “by design” approach — terms of the interests issued

ASC 810-10-25-31

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

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.

ASC 810-10-55-172 through ASC 810-10-55-181 provides an example (Case G) of the application of this concept involving a property lease entity. In that example, an entity is established with funding in the form of a five-year fixed-rate note and equity so that it can acquire property. The property is leased under a five-year lease to a lessee that has provided a residual value guarantee for the expected future value of the property at the end of five 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 is a variable interest since it 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 its accounting or legal treatment. This concept is illustrated in Example 2-4 and Example 2-5.

EXAMPLE 2-4

Interest obtained from a transaction that fails sale accounting

Assume that a reporting entity legally sells (transfers) a group of whole loans to a single-purpose securitization trust in return for cash, a beneficial interest in the trust entity (certain of the pass-through certificates issued by the trust), and a noncontingent fixed-price call option on the loans transferred.

Notwithstanding the sale of the loans’ legal title to the trust, the existence of the fixed-price call results in the transfer failing sale accounting under ASC 860, Transfers and Servicing (ASC 860). As a result, the transfer must be accounted for as a secured borrowing by both parties (i.e., the transferor borrowed from the transferee). The transferor continues to report the legally transferred loans on its
balance sheet, along with a liability corresponding to the cash received. The transferor entity does not recognize the beneficial interest in its financial statements.

Does the transferor entity hold a variable interest in the securitization trust?

*Analysis*

The transferor entity’s analysis should focus on the design of the securitization trust, the terms of all relevant agreements, and the risks intended to be passed on to its variable interest holders. The accounting characterization of the loan portfolio’s transfer, and the corresponding financial reporting of the exchange by both parties, should not affect this evaluation.

In this instance, the securitization trust legally owns the portfolio of loans, and it can be inferred that the design of the trust entity is to pass along the risks of those loans to its beneficial interest holders. For purposes of applying the VIE model, the trust’s assets consist of the acquired loans—not a receivable from the transferor. Thus the holders of the trust’s pass-through certificates, including the transferor, should be considered to hold a variable interest in the trust—despite the fact that, in the transferor’s case, the certificates are not recognized on its balance sheet (as a consequence of applying the “failed-sale” reporting model to the exchange).

The noncontingent fixed-price call option also exposes the transferor to changes in the fair value of the transferred loans. The transferor should therefore determine whether the call option represents a variable interest in specified assets, or an additional variable interest in the trust entity. If the fair value of the transferred loans represent greater than 50% of the trust entity’s total assets, the call option represents an additional variable interest in the trust entity.

In contrast, this conclusion would be different if the transferor entered into a borrowing with a prepayment option with the trust entity. If the trust entity extended credit to the transferor, the trust entity would be exposed to the transferor’s credit risk and potentially interest rate risk. The loan would therefore create, not absorb variability within the trust entity, and the transferor would not have a variable interest in the trust entity.

**EXAMPLE 2-5**

*Variable interest in lease arrangements*

A reporting entity leases one asset from an 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% of the fair value of the entity’s total assets. The lease qualifies as a capital (or finance) lease.

Does the reporting entity have variable interest in the lessor entity?

*Analysis*

The fixed-price purchase option should be viewed as a variable interest in the entity. If the entity was considered a VIE (which would be likely in this fact pattern), the reporting entity could be required to assess consolidation of the VIE under the power and losses/benefits criteria. The results achieved by consolidating the entire entity (i.e., recording both assets and the liabilities of the VIE) could be substantially different from those that would result from applying capital lease accounting to only the leased asset under ASC 840 (or finance lease accounting under ASC 842).
In contrast, the reporting entity would not have a variable interest in the lessor entity if it borrowed from the lessor entity and acquired the leased asset from a third party. Similar to Example 2-3, a loan from the lessor entity would create, not absorb variability within the lessor entity as the borrowing would expose the lessor entity to the reporting entity credit risk and potentially interest rate risk.

### 2.2.2.2 VIE “by design” approach — substantive subordination of interests

For entities that issue both senior and subordinated interests, the absorption of risks by substantive subordinated interests is a strong indicator of the variability that the entity is designed to create.

Excerpt from ASC 810-10-25-32

For legal entities that issue both senior interests and subordinated interests, the determination of which variability shall be considered often will be affected by whether the subordination (that is, the priority on claims to the legal entity’s cash flows) is substantive. The subordinated interest(s) (as discussed in paragraph 810-10-55-23) generally will absorb expected losses prior to the senior interest(s). As a consequence, the senior interest generally has a higher credit rating and lower interest rate compared with the subordinated interest. The amount of a subordinated interest in relation to the overall expected losses and residual returns of the legal entity often is the primary factor in determining whether such subordination is substantive. The variability that is absorbed by an interest that is substantively subordinated strongly indicates a particular variability that the legal entity was designed to create and pass along to its interest holders.

When considering whether a subordinated interest is substantive, we believe that all relevant facts and circumstances should be considered, including:

- The interest’s entitlement to cash flows and its relative placement in the contractual priority of payments (“waterfall”) that governs the distribution of cash flows to lenders and investors of the entity
- Yields (interest rates) of the various interests issued
- Amount and size of the subordinated interests to all other interests issued (i.e., its size in relation to the total capitalization of the entity)
- Credit ratings of the interests issued
- The nature of the investors (institutional or retail) and how the instrument was marketed

### 2.2.2.3 VIE “by design” approach — certain interest rate risk

Whether a reporting entity should consider the variability of an entity that is attributable to interest rate risk is addressed in ASC 810.

ASC 810-10-25-33

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

Example 2-6 may be helpful in applying this guidance.

EXAMPLE 2-6
Variability created by a bond investment expected to be held to maturity

Consider an entity 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.

Should the entity’s variability include interest rate risk?

Analysis

No. The entity’s variability arises from its investment in the fixed-rate bond, which exposes the entity to the issuer’s credit risk. As the issuer of the fixed-rate bond’s credit risk changes, so too will the fair value of the entity’s net assets. The entity’s variability would not, however, include variability caused by changes in interest rates since there is no planned sale of the fixed-rate bond.

Case A through Case D provided in ASC 810-10-55-55 through ASC 810-10-55-70 illustrate how to consider interest rate risk variability in the context of VIEs that hold financial assets.

2.2.2.4 VIE “by design” approach — certain derivative instruments

ASC 810-10-25-35 to 25-36 provide guidance for assessing whether certain derivative contracts create or absorb variability.

ASC 810-10-25-35

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

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

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

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.

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).

First, the contract should be analyzed to determine whether it meets the characteristics of a derivative under ASC 815, Derivatives and Hedging (ASC 815). We believe that those contracts that meet the characteristics of a derivative are eligible for consideration under the “by design” guidance, regardless of whether the contract qualifies for 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(s) (including the occurrence or nonoccurrence of a specified market observable event). ASC 815-10-15-88 through ASC 810-10-15-91 provide additional guidance on what constitutes an underlying of a derivative. Generally, normal market contracts such as LIBOR-based interest rate swaps, foreign currency contracts, and commodity futures have market observable variables.

Finally, whether the derivative contract is senior in priority (i.e., senior in the entity’s priority of payments “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(s) issued by the entity, this condition would be met.

However, the “by design” guidance specifies that even if the two conditions discussed above are met, a derivative may still be a variable interest as opposed to a creator of variability, 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. Example 2-7 illustrates this assessment.

**EXAMPLE 2-7**

**Evaluating whether a “receive-variable, pay-fixed” interest rate swap agreement is a variable interest**

An entity’s only asset is a fixed-rate bond that is funded with variable-rate liabilities. The entity enters into a “receive-variable, pay-fixed” interest rate swap, which allows the entity to pay a fixed interest rate in return for receiving a variable interest rate.

Is the interest rate swap agreement a variable interest in the entity?

*Analysis*

Yes. This swap arrangement synthetically creates a variable-rate asset, which will absorb the interest rate exposure from the fixed-rate bond. As the bond is the only asset of the entity, it may be considered
that the entity was designed to pass along the bond’s interest rate risk to the interest rate swap’s counterparty.

Refer to CG 2.2.3.5 for a further discussion of derivatives and embedded derivatives.

### 2.2.3 Examples of variable interests

Variable interests are not limited solely to equity investments.

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

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

The following are examples of common variable interests:

- □ Equity interests
- □ Beneficial interests
- □ Debt instruments
- □ Guarantees
- □ Put options
- □ Call options
- □ Management contracts
- □ Franchise arrangements
- □ Co-manufacturing arrangements
- □ Leases
- □ Co-marketing arrangements
- □ Cost-plus arrangements
- □ Forward contracts
- □ Service contracts
- □ Derivatives
- □ Residual value guarantees
- □ Purchase options
- □ Technology licenses
- □ Collaborative R&D arrangements

ASC 810-10-55-16 through ASC 810-10-55-41 provide guidance that may be helpful when determining whether common contractual and ownership arrangements are variable interests. Certain of the items listed above are discussed in further detail below. It is worth noting that the following guidance focuses on how to apply the concept of a variable interest to various instruments and contracts.

### 2.2.3.1 Variable interests — equity investments

The most obvious variable interests are equity investments. Equity investors provide capital to an entity in exchange for an ownership interest that exposes the investors to the entity’s potential losses and potential returns. Therefore, they absorb the entity’s economic risks and rewards.
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 an entity’s expected losses and receive its expected residual returns (see CG 2.3.2.4).

### 2.2.3.2 Variable interests — debt instruments and beneficial interests

A reporting entity may provide debt financing to an entity in exchange for fixed or variable returns. Because an entity’s activities and the resulting fluctuations in the fair value (or cash flows) of the entity may affect the ultimate collectability of these returns, debt instruments absorb variability. As a result, virtually all debt instruments are variable interests.

**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 (usually with fixed interest rates or other fixed returns) nevertheless are variable interests – even though the degree of variability absorbed by senior interests may be reduced by subordinated interests and the relative credit quality of the entity. ASC 810-10-55-24 elaborates on these points.

**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.

### 2.2.3.3 Variable interests — guarantees, put options, and similar obligations

**Options purchased/exercisable by the entity/options written by the reporting entity**

Entities sometimes seek to offset (hedge) 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 may
absorb the potential variability related to the entity’s operations and assets. In many cases, the writer of the contract will absorb at least some portion of the expected losses of the entity.

**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.

As discussed below, the analysis of a guarantee can differ, depending on whether the underlying or reference obligation is an asset or liability of the entity. That distinction can have major implications on the consolidation evaluation.

A guarantee of the value of an entity’s assets must first be evaluated to determine whether the contract should be considered a variable interest in the entire entity or, alternatively, should be viewed as a variable interest in the underlying, specified assets. The latter concept, known as “variable interests in specified assets,” is described in further detail in CG 2.2.7. If a guarantor has guaranteed the value of a specific asset of the entity, that guarantee is a variable interest in the entire entity only if the fair value of the guaranteed assets constitutes a majority (greater than 50%) of the fair value of the entity’s total assets.

When analyzing a guarantee of an entity’s obligations, the foregoing distinction (interest in an entity versus an interest in the underlying guaranteed item) is not relevant. These contracts are analyzed exclusively as potential variable interests in the entity, as discussed in more detail below.

Similar to a guarantee, a fixed-price put option written by a reporting entity and purchased by an entity is usually a variable interest. The entity (that purchased the put) receives the right, but not the obligation, to put (sell) the referenced 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 the underlying item 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 exchange, the writer of the put 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 – as, presumably, if the underlying assets increase in value over the put’s life, the holder of the option will not exercise it.

If a reporting entity has guaranteed a liability of an entity (effectively, a written put option), 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 option writer at a specified price, this contract usually is not a variable interest in the entity, as the option is creating variability for the entity.

**Options written by the entity**

**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 a reporting entity is a writer of a put option, the contract transfers risk of loss in the guaranteed entity to the reporting entity, and therefore creates variability for the reporting 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 (Case E; ASC 810-10-55-71 through ASC 810-10-55-74), which concludes that the credit default swap written by the entity should be considered a “creator” of variability.

If the entity writes a call option on its assets, the purchaser of this option has the right to buy an asset of the entity at a specified price. This contract is a variable interest in the asset when it absorbs the positive variability in the asset, and it may be a variable interest in the entity if the underlying asset represents more than 50% of the fair value of the entity’s total assets.

**Options written/purchased among reporting entities**

A reporting entity may write options to, or purchase options from, a counterparty with respect to an investee’s assets/liabilities/equity (e.g., the right to purchase a joint venture partner’s equity interest in the venture). These options are not direct variable interests in the investee entity since they are not related to a specific contract with the investee entity.

Even though the investee entity is not the counterparty to such options, they do alter the cash flows with respect to the variable interests held by the parties that entered into the option arrangement. Therefore, these arrangements may impact the consolidation analysis of the parties that entered into the option agreement. Example 2-8 illustrates this concept.

**EXAMPLE 2-8**

Evaluating whether a purchased call option is a variable interest when the investee entity is not the direct counterparty to the option

A venture is created whereby Company A and Company B each contributes $50 million in cash in exchange for a 50% equity ownership. Company A and Company B each has equal representation on the venture’s board of directors 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 for Company A at inception under ASC 810?

**Analysis**

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 changes in the fair value of the venture.

Conversely, if the strike price of the option is at “true” fair value of the underlying, then such an option is not a variable interest – since the option strike price fluctuates with the change in the fair value of the venture. 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 intended to approximate 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 result in calculated amounts that are close to fair value, but do not represent fair value. If so, the option may be a variable interest.

### 2.2.3.4 Variable interests — forward contracts and long-term supply arrangements

The determination of whether forward contracts or long-term supply agreements are variable interests is complex and involves careful consideration of the design of the entity. The FASB has provided only high-level guidance to assist in these assessments.

**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.

**ASC 810-10-55-28**

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.

The contract first should be evaluated to determine whether it contains a lease (considering applicable lease accounting guidance in ASC 840 (or ASC 842, if applicable)). If the contract contains a lease, then refer to CG 2.2.5 for a further discussion of evaluating leases to determine if they are variable interests. Any remaining non-lease elements should also be analyzed to determine if they are variable interests.

If the contract does not contain a 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 considering the strong indicators for derivatives in the “by
design” model (see CG 2.2.2).

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

ASC 810-10-55-81 through ASC 810-10-55-86 provide 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 a variable interest. However,
a variable exercise price 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.

If a forward contract relates to specified assets that represent less than 50% of the fair value of the
entity’s total assets, the contract would not be a variable interest in the entity (see CG 2.2.7).

Example 2-9 illustrates how a purchase and sale agreement may create a variable interest.

**EXAMPLE 2-9**

**Purchase and sale agreement with a non-refundable deposit**

Company A (reporting entity) enters into a fixed-price 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 a building. Company X’s sole assets are the land and the 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 arising from the purchase and sale
agreement?

**Analysis**

Yes. Company A will absorb some level of variability in the fair value of the land and the building as a
result of entering into the purchase and sale agreement with Company X and providing a non-
refundable deposit. Even if the buyer has the unilateral right to cancel the agreement, it still has
economic upside because the agreement to purchase the land and the building is at a fixed price.
2.2.3.5 Variable interests — other derivative instruments

ASC 810-10-55-29 through ASC 810-10-55-31 provide additional implementation guidance to assist reporting entities in evaluating whether a derivative instrument is a variable interest. This guidance augments the framework for analyzing these contracts previously discussed and should be considered from that perspective.

**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.

**ASC 810-10-55-30**

Derivatives, including total return swaps and similar arrangements, can be used to transfer substantially all of the risk or return (or both) related to certain assets of a VIE without actually transferring the assets. Derivative instruments with this characteristic shall be evaluated carefully. Determining whether a derivative contract is a variable interest may involve significant judgment. As noted above, this analysis should take into account the entity’s activities and design, and the role the derivative is intended to play in that context. For example, is the contract designed to hedge other exposures of the entity or, conversely, is it intended to expose the entity to incremental risks?

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.

**ASC 810-10-55-31**

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

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 typically are clearly and closely related to the debt instrument. However, in instances where the relevant terms introduce significant leverage or are based on factors that are not economically related to the debt instrument, the embedded feature would likely be considered other than clearly and closely related, in which case the feature should be examined to determine whether it is a variable interest. This conclusion would apply in situations where the debt includes a derivative indexed to one of the following:

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

### 2.2.3.6 Variable interests — assets of the entity

**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, as discussed in ASC 810-10-55-32.

### 2.2.3.7 Variable interests — license, royalties, and other similar arrangements

Generally, licenses, royalties, and similar arrangements are linked to an entity’s performance indicators (e.g., revenue, EBITDA). As a result, such contracts typically obligate the entity to make payments in amounts that correspond, in varying degrees, to changes in the fair value of the entity’s net assets. As such, these arrangements are considered to absorb variability in the entity and, as such, represent variable interests.

To illustrate, assume a reporting entity earns royalty from a technology license that it licensed to the entity. Periodic payments due under the royalty are based on the licensee entity’s sales. The royalty arrangement is intended to absorb, in part, the licensee entity’s variability in its sales. Thus the royalty arrangement is a variable interest of the licensee held by the licensor reporting entity.

### 2.2.4 Variable interests — decision maker or service provider fees

ASC 810 defines a decision maker as an entity or entities with the power to direct the activities of another legal entity that most significantly impact the legal entity’s economic performance. Determining whether the fees paid to an entity’s decision maker constitute a variable interest in the entity can be one of the most challenging exercises required under ASC 810’s consolidation model. The assessment is particularly complex if parties related to the decision maker also hold interests in the entity being analyzed. Moreover, the conclusion reached with respect to this matter has potentially significant “knock-on” ramifications for other key judgments, including:
Concluding whether the entity is a VIE, specifically, whether the entity’s equity holders at risk have the power to direct the activities of the entity that most significantly impact its economic performance (as discussed in CG 2.3)

If the entity is a VIE, concluding whether the decision maker is its primary beneficiary

As such, particular care must be exercised when performing this evaluation.

The consolidation model incorporates various tests and conditions to determine whether fees paid to a decision maker or a service provider should be considered a variable interest in an entity. ASC 810-10-55-37 prescribes the current framework for making this assessment.

**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.


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

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

e. Subparagraph superseded by Accounting Standards Update 2015-02.


Application of these conditions is discussed below.

For ease of reference, unless the context indicates otherwise, the term “decision maker” is intended to encompass both a decision maker and any other service providers.

2.2.4.1 **Variable interests — assessing “commensurate” and “at market”**

To be considered indicative of a fiduciary relationship, the decision-making fee arrangement must be arms-length and contain customary terms and conditions (“at market”) and represent compensation that is considered fair value for the services provided (“commensurate”).

Assessing the “commensurate” condition – We believe that the purpose of this condition is to identify arrangements that provide a decision maker with a significant off-market fee element and/or that are structured in a manner that suggests the fee is inconsistent with the decision maker’s role.
Assessing the “at market” condition – Unique provisions or terms seemingly at odds with market convention may indicate that the decision maker is serving in a manner inconsistent with a fiduciary role or relationship.

To determine whether its fee arrangement is at market and commensurate, a reporting entity may wish to consider the following factors, among other items:

- Is the entity owned by substantive third party investors?

  If the entity is owned by substantive third party investors, that fact may provide persuasive evidence that the arrangement reflects arms-length, market-based terms and conditions. It may also demonstrate that the compensation paid to the manager/service provider is fair value for the services provided.

  We believe it is reasonable to assume in many instances that independent investors would not invest in an entity that is counterparty to a services agreement that contains off-market or non-customary terms and conditions, or a fee structure that is above-market.

- Does the decision maker hold other variable interests (beyond its fee arrangement) that are unique as compared to variable interests held by the entity’s other investors?

  Decision makers often voluntarily or involuntarily make co-investments in entities they manage so that their interests are aligned with the entity’s investors. If these other interest(s) are unique in comparison to the variable interests held by the entity’s third party investors, we believe it would be inappropriate to qualitatively conclude that the arrangement is “at market” and “commensurate.” For example, a security with economic rights and privileges different from other third party investors may be unique. We believe normal decision makers that are acting in an agency capacity generally do not hold variable interests that differ from those held by the entity’s other independent investors.

  If the decision maker holds a unique variable interest, additional analysis is required to determine whether it is truly acting in an agency capacity.

  If the legal entity being evaluated is not owned by substantive third party investors and/or the decision maker holds another unique variable interest, we believe it would be inappropriate to qualitatively conclude that the decision-making fee is “at market” and “commensurate.” In those situations, additional analysis would be required to support this assertion. This analysis could include an evaluation of other fee arrangements involving other third party decision makers for the same or similar services.

  Question 2-1 addresses whether servicing arrangements that include “servicing advances” and “clean up calls” meet the “at market” condition to not be considered a variable interest.
Question 2-1
Do servicing arrangements that include “servicing advances” and “clean up calls” meet the “at market” condition 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 the “at market” condition to not be considered as a variable interest.

Fee arrangements other than decision maker or service provider fees

According to ASC 810-10-55-37C, other fee arrangements that expose the reporting entity to principal risk of loss are excluded from the evaluation of the “at market” and “commensurate” criteria, and thus are considered variable interests.

ASC 810-10-55-37C

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

a. Those related to guarantees of the value of the assets or liabilities of a VIE
b. Obligations to fund operating losses
c. Payments associated with written put options on the assets of the VIE
d. Similar obligations, such as some liquidity commitments or agreements (explicit or implicit) that protect holders of other interests from suffering losses in the VIE.

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

2.2.4.2 Variable interests — assessing other interests in the entity

ASC 810-10-55-37(c) requires a decision maker to consider the nature and extent of other interests it holds in the entity (interests other than its fee). Holding these “other economic interests” in the entity that result in the decision maker absorbing more than an insignificant amount of variability will cause the decision-making fee arrangement to be a variable interest. In addition, certain related party interests must be considered in this assessment.

The assessment of whether the decision maker’s collective other interests expose it to more than insignificant variability is both qualitative and quantitative, and requires the exercise of judgment.
New guidance

In October 2018, the FASB issued ASU 2018-17, Consolidation (Topic 810): Targeted Improvements to Related Party Guidance for Variable Interest Entities, which changed the way that certain related party interests under common control are considered in the assessment.

The provisions in ASU 2018-17 are effective for public business entities for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. For all other entities, the ASU is effective for fiscal years beginning after December 15, 2020. Early adoption is permitted, including adoption in an interim period. All entities are required to apply the amendments retrospectively with a cumulative-effect adjustment to retained earnings at the beginning of the earliest period presented.

Indirect interests held through related parties – before ASU 2018-17

ASC 810-10-55-37D articulates the framework that a decision maker must apply when evaluating indirect interests held through related parties.

Excerpt from ASC 810-10-55-37D

For purposes of evaluating the conditions in paragraph 810-10-55-37, any interest in an entity that is held by a related party of the decision maker or service provider should be considered in the analysis. Specifically, a decision maker or service provider should include its direct economic interests in the entity and its indirect economic interests in the entity held through related parties, considered on a proportionate basis. For example, if a decision maker or service provider owns a 20 percent interest in a related party and that related party owns a 40 percent interest in the entity being evaluated, the decision maker’s or service provider’s interest would be considered equivalent to an 8 percent direct interest in the entity for the purposes of evaluating whether the fees paid to the decision maker(s) or the service provider(s) are not variable interests (assuming that they have no other relationships with the entity). Indirect interests held through related parties that are under common control with the decision maker should be considered the equivalent of direct interests in their entirety.

We believe that the terms “indirect interest” and “indirect economic interest,” which are used interchangeably in the guidance, are intended to mean indirect variable interest in all cases. To have an indirect interest, a decision maker must have a direct variable interest in a related party that, in turn, has a direct and/or indirect variable interest in the entity being evaluated for consolidation.

Although this requirement may appear straightforward, the analysis will become more complex when the economic interests held deviate from “plain vanilla” equity interests held by the decision maker in the related party, and/or by the related party in the entity being evaluated for consolidation. For example, the decision maker may hold a convertible preferred equity investment in the related party that in turn holds a debt investment in the entity being evaluated for consolidation.

For purposes of applying the indirect interest concept, related party relationships should broadly be segregated between related parties that are under common control, and those that are not, as discussed more fully below.

The FASB has acknowledged that there is no standard definition of the concept of “common control.”
Excerpt from BC69 in ASU 2015-02

Current GAAP uses the term common control in multiple contexts, and the term is not defined in the Master Glossary. Therefore, for purposes of evaluating the criteria in paragraphs 810-10-25-42, 810-10-25-44A, and 810-10-55-37D, the Board’s intent was for the term to include subsidiaries controlled (directly or indirectly) by a common parent, or a subsidiary and its parent.

Refer to BCG 7.2.1 for information about assessing whether common control exists.

If the decision maker and the related party are under common control, then the entirety of the interest held by the related party in the underlying entity should be attributed to the decision maker.

Note that the treatment of interests held by a commonly controlled related party for purposes of applying ASC 810-10-55-37 differs from the manner in which such interests are considered in the primary beneficiary assessment. Refer to CG 2.4.5 for further discussion.

Indirect interests held through related parties — after ASU 2018-17

Prior to ASU 2018-17, indirect variable interests held by related parties were considered on a proportionate basis, unless those interests were held by related parties under common control.

In October 2018, the FASB issued ASU 2018-17, Consolidation (Topic 810): Targeted Improvements to Related Party Guidance for Variable Interest Entities, which allows decision makers to treat indirect interests in a VIE held through related parties under common control on a proportionate basis as well.

The amendments in ASU 2018-17 align how interests held by a commonly controlled related parties are treated for the purposes of applying ASC 810-10-55-37 to how they are considered for the primary beneficiary assessment. Refer to CG 2.4.5 for further discussion and an example.

The change is intended to result in more decision makers being deemed to be acting in an agency capacity and ultimately reduce the risk that decision makers with little to no direct and indirect variable interests could nonetheless be deemed the primary beneficiary of a VIE.

ASC 810-10-55-37D articulates the framework that a decision maker must apply when evaluating indirect interests held through related parties.

Excerpt from ASC 810-10-55-37D

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

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

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

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

To have an indirect variable interest, a decision maker must have a direct variable interest in a related party that, in turn, has a direct and/or indirect variable interest in the entity being evaluated for consolidation. Although this requirement may appear straightforward, the analysis will become more complex when the economic interests held deviate from “plain vanilla” equity interests held by the decision maker in the related party, and/or by the related party in the entity being evaluated for consolidation. For example, the decision maker may hold a convertible preferred equity investment in the related party that in turn holds a debt investment in the entity being evaluated for consolidation.

Example 2-10 illustrates the determination of whether a decision-making fee is considered a variable interest in a VIE.

**EXAMPLE 2-10**

**Determining whether a decision-making fee is considered a variable interest in a VIE**

Subsidiary A and Subsidiary B are under common control of Reporting Entity X. Subsidiary A has a 15% equity interest in Subsidiary B. Subsidiary A has entered into a management contract with a fund, determined to be a VIE, whereby it receives a management fee that is considered at market and commensurate. Subsidiary B has a 20% equity interest in the fund.
Is Subsidiary A’s management fee considered a variable interest in the VIE?

**Analysis**

No. Subsidiary A’s indirect interest in the VIE on a proportionate basis results in a 3% (15% × 20%) economic interest in the fund, which Subsidiary A would likely conclude is not more than insignificant. Therefore, its management fee would not be a variable interest and Subsidiary A would be considered to be operating in an agency capacity. Prior to adopting ASU 2018-17, Subsidiary A would have treated its indirect interest in the VIE as if it held Subsidiary B’s 20% interest directly, which likely would have been more than insignificant.

See ASC 810-10-65-9 for transition guidance related to the amendments in ASU 2018-17, including guidance for instances when a reporting entity is required to consolidate or deconsolidate a legal entity as a result of the initial application of the ASU.

**Consideration of employees and employee benefit plans**

A decision maker’s employees or employee benefit plans may hold variable interests in the entity being evaluated for consolidation by its decision maker. Although employees and employee benefit plans may be related parties of a decision maker, the decision maker need not consider those interests when evaluating criterion (c) in ASC 810-10-55-37 unless those employees or plans are being used to circumvent the VIE guidance more generally. ASC 810-10-55-37D clarifies this matter.

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

The term *related parties* in this paragraph refers to all parties as defined in paragraph 810-10-25-43, with the following exceptions:

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

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

ASC 810-10-55-37D does not specifically state whether the portion of any interest held by a decision maker’s employees or employee benefit plan that has been financed by the decision maker should be deemed an indirect interest attributable to the decision maker. In contrast, for purposes of the primary beneficiary analysis, ASC 810-10-25-42 explicitly states that a decision maker should treat the portion of any employee interests that it has financed as an indirect economic interest.

In our view, if a decision maker contributes to its employee benefit plans, and the employee benefit plans in turn make independent decisions to invest in an entity, we believe the interests held by the employee benefit plans should not be attributed to the decision maker in connection with its evaluation of potential “other economic interests” held by related parties under ASC 810-10-55-37D.

On the other hand, if a decision maker provides financing for a specific interest held by an employee or employee benefit plan as part of the design of the underlying entity, and that funding is atypical or
inconsistent with past practice, those arrangements may be indicative of efforts to circumvent the consolidation rules. If the facts and circumstances suggest that the arrangements were structured principally to achieve a desired accounting outcome, we believe that those financed interests should be attributed to the decision maker for purposes of assessing the “other economic interests” criterion.

**Evaluating “more than insignificant”**

ASC 810-10-55-37(c)’s “other economic interests” criterion requires the decision maker to assess the significance of its other economic interests in an entity. In that assessment, the decision maker should consider those interests’ relative exposure to the entity’s expected losses and relative entitlement to the entity’s expected residual returns. Each of these concepts is a defined term in the ASC Master Glossary. ASC 810-10-55-37D provides useful guidance regarding the application of these concepts.

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

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

Judgment is required when assessing whether other economic interests held by (or attributed to) a decision maker absorb more than an insignificant amount of an entity’s expected losses or receive more than an insignificant amount of an entity’s expected residual returns. Although this assessment must still benchmark those interests against the entity’s expected losses and expected residual returns, it is clear from the foregoing excerpt that the FASB does not intend for this requirement to be demonstrated by detailed computational analyses. Rather, preparers are to exercise judgment in performing a qualitative assessment of the economics provided by any other interests they hold.

Additionally, “more than an insignificant amount” is not defined in the context of the consolidation model. However, the concept is intended to mean the same as “significant” — said differently, a “more than insignificant amount” does not imply or contemplate a threshold (or range) that falls somewhere between “insignificant” and “significant.” Although a “more than insignificant amount” cannot be reduced to a “bright line,” we believe that the interpretation of “more than insignificant” is a fairly low threshold and it is reasonable to view 10% or more as presumptively indicative of other interests constituting a “more than insignificant amount.”

When evaluating the significance of other economic interests held by (or attributed to) a decision maker relative to the entity’s anticipated variable returns, the following factors or indicators may be useful:

- The size of the interest to the overall capitalization of the entity
- The commercial reasons behind the decision maker’s ownership of those interests

For example, consider situations in which investments by the decision maker were made to support marketing of investments into the entity. In this case, it may indicate that the decision maker made such investment to signal to others that the decision maker is willing to put its own interests at risk. This may indicate that the decision maker is not acting as a fiduciary as it made the investment to demonstrate to the other investors that it has “skin in the game.”
2.2.4.3 Variable interests — reconsidering decision maker and service provider arrangements

CG 2.4 describes reconsideration events to re-evaluate whether or not an entity is, in fact, a VIE under the VIE model. 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 whether the reassessment of a decision maker’s arrangement as a variable interest should be based on reconsideration events or should be carried out on a continuous basis. We believe that the decision about when to reassess the conclusion is a policy choice by the reporting entity.

Regardless of which policy is elected, the assessment should focus on events that would incentivize the decision maker to begin acting as a principal, or conversely, would suggest the decision maker is acting in an agency capacity, such as:

- Changes in the terms of the management or service provider arrangement
- The decision maker or service provider’s acquisition or disposition of variable interests in the entity being evaluated for consolidation (either directly or through their related parties)

2.2.5 Variable interests — leases

Guidance on how to apply the VIE model to leases is found in ASC 810-10-55-39.

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.

2.2.5.1 Variable interests — entity is the lessor

Lease receivables of the entity are not variable interests. Rather, receivables from 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**

  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 is exercised, the lessor entity’s 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% of the fair value of the lessor 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.

- **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 lessor entity’s 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% of the fair value of the lessor entity’s total assets, it would not be a variable interest in the entity; rather it would be a variable interest in specified assets.

- **Lessee renewal options**

  Renewal options in leases with rental payments 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 (or ASC 842-10-20), the renewal option is a variable interest because it provides the lessee with the right to lease the assets for a period beyond the original lease term for rental payments that potentially differ from fair value. Thus, the renewal option captures a portion of the residual value of the asset.

  However, if the renewal option is solely for specified assets that represent less than 50% of the fair value of the lessor 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.

- **Lease prepayments to the lessor**

  Lease prepayments to a lessor entity are in substance a loan that will be repaid over the term of the leased asset. Because a loan is generally a variable interest in the debtor, lease prepayments similarly should be considered a variable interest in the lessor entity.
See CG 2.4 for primary beneficiary analysis, particularly with respect to certain single asset owning special purpose entities (lessor entities).

2.2.5.2 **Variable interests — entity is the lessee**

When the entity is the lessee, the lease should be treated like a debt instrument since these arrangements are, in essence, financing arrangements. That is, a lessor entity would generally be viewed as having a variable interest in the entity to which it leases an asset.

2.2.6 **“Implied” variable interests**

When applying the VIE model, in addition to assessing all explicit, direct interests in an entity, a reporting entity should evaluate whether any “implicit” variable interests exist in the entity. Implicit variable interests sometimes, but not exclusively, manifest themselves in situations where two related parties are involved with an entity, but only one has a direct variable interest in the entity. If deemed to exist, an implicit variable interest is treated no differently than an explicit variable interest when applying the VIE model.

An implicit variable interest is described as an interest that absorbs or receives the variability of an entity indirectly, rather than through direct interests in the entity.

**ASC 810-10-25-51**

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

ASC 810-10-25-52 elaborates on the concept of an implied variable interest.

**ASC 810-10-25-52**

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 legal entity from absorbing losses incurred by the legal entity.

In practice, the concept of an implied variable interest is generally used to describe two types of arrangements:

1. Variable interests “around” an entity

2. Noncontractual variable interests
Variable interests “around” an entity are often easier to identify as they arise from contractual relationships between parties involved with the entity being evaluated for consolidation. The following list of questions, which is not intended to be all-inclusive, may assist in identifying variable interests around an entity being evaluated for consolidation:

- Was the arrangement entered into in contemplation of the entity’s formation?
- Was the arrangement entered into contemporaneous with the entity’s issuance of a variable interest to another party?
- 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?

Noncontractual variable interests are more difficult to identify given the absence of explicit contractual relationships. Identifying implied variable interests stemming from noncontractual arrangements will depend on facts and circumstances and require the use of judgment. When performing this analysis, a reporting entity may find it useful to consider the impediments and incentives to why one entity would choose to protect another party involved with the entity being evaluated for consolidation from the entity’s expected variability.

The following table describes potential matters to consider when assessing one entity’s impediments and incentives to protect another party involved with an entity being evaluated for consolidation from its expected variability:

<table>
<thead>
<tr>
<th>Impediments to protect</th>
<th>Incentives to protect</th>
</tr>
</thead>
<tbody>
<tr>
<td>□ Does the reporting entity have the capacity to provide protection to the other party involved with the entity? If so, in what form and to what extent?</td>
<td>□ Is the reporting entity a related party, have other fiduciary responsibilities to the other party, or under common control with the other party?</td>
</tr>
<tr>
<td>□ Is the reporting entity subject to any debt covenants or similar contractual restrictions that would prevent it from protecting the other party involved with the entity?</td>
<td>□ How important is the arrangement to the reporting entity’s commercial success? Can the assets held by the entity being evaluated for consolidation be replicated, and/or can the reporting entity readily relocate the entity’s operations?</td>
</tr>
<tr>
<td>□ Are there regulatory or statutory provisions that could constrain or prevent the reporting entity from providing protection to the other party involved with the entity, and/or could any such action raise other legal concerns, such as potential conflicts of interests?</td>
<td>□ What are the consequences, if any, for the reporting entity in the event that the other party involved with the entity defaults on any of its obligations?</td>
</tr>
</tbody>
</table>

### 2.2.7 Variable interests in specified assets

ASC 810-10-25-55 through ASC 810-10-25-58 clarify under what circumstances a reporting entity should be considered to hold a variable interest in specified assets of an entity – rather than in the entity itself.
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.

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)
- The reporting entity 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. In contrast, a guarantee on the repayment of debt that 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.

Example 2-11 illustrates the application of the variable interest in specified assets concept.

**EXAMPLE 2-11**

Assessing variable interests in specified assets

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 at least $4 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 million at the end of the lease’s term. Neither Reporting Entity A nor Reporting Entity B has other interests in the entity as a whole.

Does Reporting Entity A or Reporting Entity B have a variable interest in the entity?

**Analysis**

*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 absorbs changes in the fair value of an asset that represents more than 50% of the total fair value of the entity’s assets (the fair value of the building is 57% 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 protects the value of an asset that represents less than 50% of the total fair value of the entity’s assets (the fair value of the asset is only 43% of the total assets). Since the residual value guarantee is not a variable interest, it is viewed as a creator rather than an absorber of variability. This is due to the fact that the residual value creates a floor for the fair value of the protected asset.

The determination of whether a variable interest is held in an entity or in a specified asset of the entity is based solely on the fair value of the asset relative 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 assets that represent 90% of the entity’s assets (on a fair value basis) may be limited to 10% of the total loss in value of those assets. Although limited, that guarantee would constitute a variable interest in the entire entity.

2.2.7.1 How variable interests in specified assets affect expected losses

Whether a variable interest in specified assets is considered an interest in the entity that owns those assets or, instead, an interest in only those assets, can have repercussions on the consolidation analysis for the entity in question.

ASC 810-10-25-56

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

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. As a consequence, 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 in specified assets of an entity is a variable interest in the entity as a whole, the losses related to those specified assets intended to be absorbed by the variable interest are included in the determination of the entity’s expected losses for the purposes of determining whether the entity is a VIE (refer to CG 2.3.3.1 for information on assessing the sufficiency of an entity’s equity investment). Said differently, the measurement of 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 2-11 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).
2.2.8 Silos: a VIE within a VIE

As noted in CG 2.2, the “unit of analysis” for purposes of applying the VIE model is a legal entity. Accordingly, a presumption exists that “virtual entities” – for example, a particular pool of assets owned by a legal entity that is pledged to secure an obligation of the entity – are not separate entities that warrant a discrete consolidation analysis. Unless the specific conditions discussed below are present, the overarching legal entity serves as the unit of analysis under ASC 810.

The FASB was concerned that VIEs could be structured to separate the rights and obligations of different parties within an overarching legal entity, thereby allowing those parties to avoid consolidation. As a result, the guidance includes 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 only selected assets of the all-in legal entity.

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.

ASC 810-10-25-58 emphasizes that, to be considered a silo, the underlying arrangements must meet stringent criteria indicative of a stand-alone, de facto entity.

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 restrictive guidance, we believe that silos will exist in very limited circumstances, and may be given recognition only if the following conditions are met:

- Specified assets, specified liabilities, and specified equity (if applicable) are clearly identifiable and separate from the overall entity
- Essentially (1) none of the returns from the separate assets are available to holders of interests in the larger VIE and (2) the specified liabilities are not paid using assets of the larger VIE
- The entity as a whole is a VIE
2.2.8.1 How silos affect the VIE analysis

A silo can exist only within a legal entity deemed to be a VIE. If the silo is deconsolidated from the larger VIE, expected losses and expected residual returns attributable to the silo should be excluded from the calculation of expected losses and expected residual returns of the larger legal entity. The analysis involves the following steps:

□ 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 assessment of the larger legal entity. However, because silos exist in relatively few instances, we expect that most reporting entities will find it unnecessary to undertake this more exhaustive analysis.

2.3 Determining whether an entity is a VIE

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 which party has a controlling financial interest in the entity. The VIE model assumes that the holders of voting equity 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 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

The VIE model requires the reporting entity to determine whether an entity is a VIE at the time of its creation (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.

The reference to “equity” in the above characteristics of a VIE refers to equity that is considered at risk. “Equity at risk” is a defined term and identifying it is an important first step in applying the VIE model.
2.3.1 **Identifying the holders of the equity investment at risk**

**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.

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 presented as equity does not necessarily mean that it qualifies as equity at risk. A careful analysis is necessary to ensure that an equity investment meets the conditions necessary to qualify as equity at risk.

Figure 2-2 provides an overview of how the amount of an entity’s total equity investment at risk is calculated:

**Figure 2-2**

*Calculating an entity’s total equity investment*

<table>
<thead>
<tr>
<th>GAAP equity investment</th>
<th>Less: Equity investments that do not participate significantly in the entity’s profits and losses (see ASC 810-10-15-14(a)(1))</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Less: 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></td>
<td>Less: 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></td>
<td>Less: 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>
</tbody>
</table>

2.3.2 **Equity at risk — starting point: GAAP equity**

The starting point for identifying equity at risk is the capital that is reported as equity under GAAP.
2.3.2.1 Equity at risk — is it at risk?

After the components of GAAP equity are identified, the next step is to assess whether the equity is considered at risk. There are four conditions (see CG 2.3.1) that a reporting entity must consider to conclude that GAAP equity is at risk for purposes of applying the VIE model. If a potential VIE has more than one investor, a reporting entity must evaluate each investment separately against the four conditions described below.

2.3.2.2 Equity must participate significantly in profits and losses

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.

We believe the term “profits and losses” refers 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 such circumstances, the equity investment would not be considered equity at risk.
Example 2-12 illustrates the determination of whether an equity investment with a guaranteed minimum return qualifies as equity at risk.

**EXAMPLE 2-12**

**Determining whether an equity investment with a guaranteed minimum return qualifies as equity at risk**

Company A contributed $1,000 of cash into Entity B at formation in exchange for 20% of Entity B’s common stock. Company A’s common equity investment participates pro rata in Entity B’s profits and losses; however, the terms of Company A’s interest stipulate that it must receive, at a minimum, an annual 8% rate of return on its investment.

Does Company A’s equity investment participate significantly in Entity B’s profits and losses?

**Analysis**

Generally, no. Although Company A’s equity investment may participate significantly in Entity B’s profits, the minimum guaranteed return demonstrates that Company A may not necessarily participate significantly in Entity B’s losses. As a result, assuming Company A’s guaranteed minimum return is substantive (i.e., Entity B has adequate equity that is (1) subordinated to Company A’s equity investment, and (2) capable of funding Company A’s guaranteed minimum return in periods where Company B incurs operating losses), Company A’s equity investment may not qualify as equity at risk.

Even when an equity investment participates in the profits and losses of a potential VIE, the investment’s level of participation must be “significant” for that equity investment to qualify as equity at risk.

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 factors should be considered when making this assessment.

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

Investments with a fixed rate of return generally do not participate significantly in the profits and losses of an entity. However, the substance of an arrangement should prevail over its form. If an equity investor is entitled to a fixed rate of return and that return is substantial relative to the entity’s overall equity return, the equity investment may participate significantly in the entity’s profits. To qualify as equity at risk, an equity investment must also participate significantly in the entity’s losses.

**Determining whether an equity investment is substantive**

An equity investment that participates in an entity’s profits and losses at a level that is consistent with its relative equity ownership (e.g., a 1% general partnership interest that participates in 1% of the entity’s profits and losses) would participate significantly in profits and losses as long as that equity investment is substantive.

Sometimes equity interests are issued for de minimis amounts and, as a result, that investor may not participate significantly in losses.
Example 2-13 illustrates the determination of whether a general partner interest participates significantly in a limited partnership’s profits and losses.

**EXAMPLE 2-13**

Determining whether a general partner interest participates significantly in a limited partnership’s profits and losses

A general partner purchases a 1% general partner interest for $1,000, while 99 limited partners each receive a 1% interest for their contributions of $1,000,000 ($99 million in total).

Does the general partner’s interest participate significantly in the limited partnership profits and losses?

*Analysis*

No. Under this scenario, the general partner’s interest would not participate significantly in the profits and losses based on what the general partner paid for its 1% interest relative to the price paid by the LPs for their 1% interests (i.e., it is not substantive). In making this assessment, we believe the dollar amount and percentage of the investment relative to the total equity investments should be considered.

The general partner’s interest would be substantive and therefore qualify as equity at risk if (1) the general partner contributed $1 million for its 1% pro rata equity investment (like all other investors) and (2) the general partner’s investment participated pro rata in the limited partnership’s profits and losses. However, if the general partner’s percentage interest is trivial (i.e., 0.1%) then its investment would not be at risk irrespective of the price paid.

*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.

*Equity instruments that are redeemable or callable*

Oftentimes, investors can put (redeem) their equity interests (purchased put options) or are required to sell their equity interests to a third party at the third party’s option (written call options). These put and call options are often exercisable at fixed prices or prices determined based on a formula. In determining whether these features would prevent an equity investment from participating significantly in the profits and losses of the entity, we believe a reporting entity should first determine whether those characteristics are embedded in the terms of the equity investment. Embedded terms are part of the equity investment’s features so they must be considered in the analysis. Freestanding puts and calls on equity may have to be included in the equity at risk analysis, as discussed further below.

*Puttable or callable characteristics arising from a freestanding contract*

When the puttable or callable characteristics result from a freestanding contract with a third party (i.e., a party that is not involved with the potential VIE) that was not executed as part of the entity’s purpose and design (e.g., as part of the equity investor’s normal trading activities), we do not believe
the puttable or callable characteristics would preclude that equity interest from qualifying as equity at risk.

If, however, the equity investor executed the freestanding contract with the potential VIE or a party involved with the potential VIE as part of the purpose and design of the entity, we believe these characteristics would need to be considered in the analysis and may preclude the equity interest from qualifying as equity at risk if they substantively protect the investor from losses, or prohibit the investor from participating significantly in the entity’s profits.

If the puttable or callable characteristics are embedded in the terms of the contract, or arise from a freestanding contract executed as part of the design of the potential VIE, the following factors should be considered to determine whether the equity investment qualifies as equity at risk:

□ The length of the period of time during which the put or call option may be exercised

□ Terms associated with the put or call option, including the option’s strike price (e.g., fixed, variable, or fair market value)

If an equity investment is puttable or callable at the instrument’s then current fair value, or at a fixed price that is significantly out-of-the-money, that investment would likely participate significantly in the profits and losses of the potential VIE. In contrast, if the equity investment is puttable or callable at a fixed price that is in-the-money or at an amount that is not significantly out-of-the-money, we believe the investor may not participate significantly in the potential VIE’s profits and losses. This would preclude the underlying equity interest from qualifying as equity at risk.

Judgment may be required when an equity instrument is puttable or callable at an amount that is determined by a formula. Specifically, a reporting entity should consider whether the formula amount substantively limits the equity investor’s exposure to the entity’s profits or losses.

Question 2-2 addresses whether a hybrid equity instrument containing an embedded derivative requiring separation under the provisions of ASC 815-15-25 can qualify as an equity investment at risk.

Question 2-2

Does a hybrid equity instrument that contains an embedded derivative requiring separation under the provisions of ASC 815-15-25 qualify as an equity investment at risk?

PwC response

It depends. An embedded derivative that must be separated from its host contract pursuant to 815-15-25 must be classified as an asset or liability, and therefore would be excluded from the total equity investment at risk. However, the residual value ascribed to a host contract that is accounted for as GAAP equity might qualify as equity investment at risk, assuming the host contract meets the other necessary requirements. A reporting entity should determine whether the GAAP equity-classified host contract participates significantly in the potential VIE’s profits and losses to determine whether that equity investment qualifies as equity at risk. The equity classified host contract would not qualify as equity at risk if, for example, the separated derivative was a put option that is not significantly out-of-the-money. In that circumstance, the put option would protect the equity investor(s) from the entity’s expected losses, thereby disqualifying the equity classified host instrument from the potential VIE’s total equity investment at risk.
2.3.2.3  **Equity issued for subordinated financial support in another VIE**

**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).

Example 2-14 illustrates the determination of whether an equity investment acquired in exchange for a subordinated interest in another VIE qualifies as equity at risk.

**EXAMPLE 2-14**

Determining whether an equity investment acquired in exchange for a subordinated interest in another VIE qualifies as equity at risk

Reporting Entity X contributed $1,000 of cash to Entity A, a VIE, at formation in exchange for a 30% equity interest in Entity A. Reporting Entity X then contributed its 30% equity interest in Entity A to Entity B in exchange for 40% of Entity B’s common equity.

Does Reporting Entity X’s common equity investment in Entity B qualify as equity at risk?

**Analysis**

No. Reporting Entity X’s equity investment in Entity B is not considered equity at risk since the equity investment was acquired in exchange for a subordinated interest issued by another VIE, Entity A.

If, however, Entity A was not a VIE, then Reporting Entity X’s equity interest in Entity B would be considered equity at risk assuming all other criteria in ASC 810-10-15-14(a) were met.

2.3.2.4  **Equity provided by other parties involved with the entity**

**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 obtained through fees, a charitable contribution, or other forms of payment made to the investor from another party involved with the entity. Stated differently, only an equity investment made by an equity investor that has “skin in the game” is considered equity at risk.

A literal reading of the guidance suggests that all fees paid to an equity investor by the potential VIE, or by others involved with the potential VIE, would reduce the entity’s equity investment at risk. We
believe that the facts and circumstances should be considered when determining whether such fees are, in substance, a return of capital and therefore reduce the amount of equity at risk.

ASC 810 provides the following examples of factors that can result in a reduction in an investor’s at-risk equity:

- **Upfront fees and fees paid over time:** Generally, fees paid concurrent with the formation of an entity (or shortly thereafter) would be considered a return of the amounts invested by the equity investor. Examples of such fees include structuring, syndication, management, or development fees.

Payments and fees paid by any party that was involved with the entity should be evaluated to determine whether they disqualify the investor’s equity investment, in whole or in part, from being at risk.

Example 2-15 illustrates the determination of the impact of upfront fees paid to an equity investor on the calculation of total equity investment at risk. Example 2-16 illustrates the determination of whether a general partner’s equity investment qualifies as equity at risk when purchased using fees received from the entity.

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**EXAMPLE 2-15**

Demonstrating the impact of upfront fees paid to an equity investor on the calculation of total equity investment at risk

Company A contributed $15 of cash to Entity B at formation in exchange for 100% of Entity B’s common equity. Entity B subsequently obtained $85 of nonrecourse debt and paid Company A $10, which represents a fee for development services Company A will perform in the future. The fee paid to Company A is fair value for the future services to be provided.

Does the fee paid by Entity B to Company A prevent Company A’s equity investment, in whole or in part, from being considered equity at risk?

**Analysis**

Yes. Company A’s equity investment at risk must be reduced by the amount of upfront fees received from Entity B for future development services. As such, the equity investment at risk would be $5, calculated as Company A’s $15 capital contribution less the $10 upfront development fee received from Entity B for future development services.

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**EXAMPLE 2-16**

Determining whether a general partner’s equity investment qualifies as equity at risk when purchased using fees received from the entity

A general partner forms a limited partnership and receives a $100 syndication fee. The general partner then contributes $10 for a 1% general partner interest.

Does the general partner’s 1% equity interest qualify as equity at risk?
Analysis

No. The general partner’s investment would not qualify as equity at risk since an upfront fee received from the limited partnership for services provided was used to fund the purchase of its interest.

- **Third party reimbursements:** Generally, payments that an equity investor receives from the entity that are used to pay an unrelated third party for a service performed for the entity would not affect the amount of the investor’s equity investment that would be considered at risk. The investor would not benefit from the monies received, so the amount invested in the entity would still be considered equity at risk.

- **Fees paid over time:** If an equity investor is entitled to future fees that are at market and commensurate (refer to CG 2.2.4.1 for further discussion), its equity at risk would not be reduced by any portion of the future fees. In contrast, if the investor is entitled to future fees that are above market, and the investor is unconditionally entitled to such fees, then the present value of the total expected fee that exceeds the market rate should be treated as a reduction of the potential VIE’s total equity at risk. We believe such amounts represent, in substance, a guaranteed return on the investor’s equity interest.

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. Question 2-3 addresses whether “sweat equity” can meet the criteria for being included in the equity investment at risk.

**Question 2-3**

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

**PwC response**

No. Sweat equity is not considered equity at risk. In effect, sweat equity is financed for the equity investor (service provider) by the potential VIE.

**2.3.2.5 Equity financed by the entity or other parties involved with the entity**

**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 providing the loan to the equity investor or guaranteeing debt financing used by the equity investor to fund its interest, as opposed to the equity investors. ASC 810 specifically prohibits equity investments from qualifying as equity at risk when the source of funds used by the equity investor to acquire its equity interest are provided by (1) the potential VIE or (2) other parties involved with the potential VIE, unless those other parties are included in the same set of consolidated financial statements as the equity investor.

If the borrowed funds were received from an individual or entity that is not involved with the potential VIE, then the equity investment acquired using the borrowed funds would be considered equity at risk, assuming it meets all other necessary conditions.

Example 2-17 illustrates the determination of whether an equity investor’s interest is at risk when purchased using borrowed funds from a party involved with the VIE.

**EXAMPLE 2-17**

Determining whether an equity investor’s interest is at risk when purchased using borrowed funds from a party involved with the VIE

Investor A loans Investor B $500, and Investor B uses the $500 to acquire a 50% interest in Partnership X. Investor A contributes $500 in cash and also receives a 50% interest in Partnership X. Investor A and Investor B are each required to consent to all decisions related to Partnership X’s activities that most significantly impact its economic performance (i.e., power is shared).

*Analysis*

Investor B’s equity investment is excluded from total equity investment at risk because Investor A provided the financing for that investment. In addition, Investor A and Investor B would be considered VIE related parties (de facto agents), which could have ramifications if Partnership X is a VIE and neither Investor A nor Investor B meet both conditions necessary to be the primary beneficiary of Partnership X on a stand-alone basis.

A reporting entity that makes a contribution or loan to another party that is used to acquire an equity interest in a potential VIE would create a de facto agency relationship as discussed in CG 2.4.2.5. This may have significant ramifications when determining whether a decision-making fee is a variable interest (refer to CG 2.2.4), and whether a variable interest holder is the primary beneficiary of a VIE (refer to CG 2.4).

**2.3.2.6 Equity at risk — activities around the entity**

Conceptually, reporting entities are required to consider activities “around the entity” to capture circumstances where entities are structured to avoid consolidation. Examples of relationships or transactions “around the entity” that should be considered when assessing whether an investor’s equity interest qualifies as equity at risk include the following:

- Loans between an entity’s equity investors
- Purchased and sold put and call options
- Service arrangements with investors and non-investors
- Derivatives financial instruments (e.g., total-return swaps)

If relationships and transactions “around the entity” prevent the holders of equity at risk from participating significantly in the entity’s profits and losses, then those equity investments should be excluded from the calculation of equity at risk. If those transactions or relationships cause some or all of the entity’s equity investments to be excluded from equity investment at risk, this could lead to the conclusion that the entity is VIE due to insufficient capitalization. Refer to CG 2.3.1 for further discussion.

2.3.3 **Assessing the five characteristics of a VIE**

Once the holders of equity investment at risk have been identified, the reporting entity should determine whether any of the five characteristics of a VIE as described in ASC 815-10-15-14 are present. If a single VIE characteristic is present, then the entity is a VIE and the reporting entity must determine whether it is the VIE’s primary beneficiary (as discussed further in CG 2.4).

2.3.3.1 **VIE characteristic 1: insufficient equity investment at risk**

The first characteristic of a VIE focuses on the sufficiency of the potential VIE’s total equity investment at risk. An entity is sufficiently capitalized when its total equity investment at risk is sufficient to finance its expected activities without additional subordinated financial support. If the potential VIE requires additional subordinated financial support to finance its expected activities, then Characteristic 1 would be present and the party providing the additional financing may restrict or even prohibit the equity investors from making decisions that are counter to the interests of the parties providing additional financing. Consequently, placing primary reliance on voting rights (as prescribed by the voting interest model) may not result in an accurate conclusion regarding which party holds a controlling financial interest.

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

To determine whether Characteristic 1 is present, a reporting entity should evaluate whether the potential VIE’s total equity investment at risk exceeds the potential VIE’s total expected losses (i.e., the potential negative variability in the returns of the entity). To be sufficient, the potential VIE’s equity at risk must be large enough to absorb the potential downside variability of the entity’s activities (its expected losses). If the total equity investment at risk is less than the potential VIE’s total expected losses, the entity would not be sufficiently capitalized and therefore would be a VIE.
When calculating total equity investment at risk, we believe the securities comprising equity should be evaluated based on their fair value as of the date the analysis is performed. That date may differ from the entity’s formation date if the reporting entity became involved with the potential VIE post-inception.

In some instances, the book value of the entity’s equity may equal its fair value, or be a reasonable proxy for its fair value. Other times, an entity’s book value of equity is not a reasonable proxy for its fair value. There are cases when, even at formation, the fair value of an entity’s equity differs from its book value. This would be the case, for example, in the formation of a joint venture, where the venture is required by GAAP to record equity contributions at carry-over historical cost. Because the concepts of variable interests and expected losses are based on fair value assumptions, using the fair value of an entity’s equity will provide for consistent comparisons when evaluating whether an entity is a VIE.

The VIE model establishes a rebuttable presumption that all entities with equity investment at risk of less than 10% of the fair value of the entity’s total assets are VIEs. However, that presumption may be overcome using qualitative or quantitative evidence demonstrating that the equity investment at risk of less than 10% may be sufficient.

**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 investment at risk of more than 10% is automatically deemed sufficient.

**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.

The VIE model does not provide “rules” for determining what amount of equity is required to be sufficient. The 10% presumption does not provide a safe harbor for all equity investments that are equal to, or greater than, 10% of the fair value of an entity’s total assets. Reporting entities involved with potential VIEs must demonstrate that the equity investment at risk is sufficient if the equity exceeds 10% of the fair value of the potential VIE’s assets.

**Qualitatively demonstrating that the equity investment at risk is sufficient**

**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.

ASC 810-10-25-45(a) through (b) provides two indicators that a reporting entity can consider to demonstrate that an entity is sufficiently capitalized. If either of these qualitative conditions provide evidence that the entity is sufficiently capitalized, the presumption that the entity is thinly capitalized can be overcome and the entity would not be a VIE under Characteristic 1.

- **Ability to finance activities without additional subordinated financial support**: Entities that have issued investment-grade senior debt may be able to qualitatively demonstrate that the entity can finance its operations without additional subordinated financial support. Entities that have issued low-risk debt demonstrate that they are able to obtain financing that is low-risk with an interest rate that is commensurate with those low-risk activities. Even if the entity has issued subordinated debt, there may be circumstances when the entity can demonstrate that it has sufficient equity at risk, for example, if the subordinated debt carries an investment grade credit rating. The grade and related interest rate of the subordinated debt must be evaluated to determine whether it is comparable with the grade and interest rate of other low-risk (i.e., “debt-like”) investments.

Depending on the nature and grade of the entity’s debt and other financing, the entity may be unable to qualitatively demonstrate that its equity at risk is sufficient, even if it has diversified assets and risks. If the potential VIE issued debt that is more “equity-like” in nature, we believe the reporting entity will be unable to qualitatively conclude that the entity is sufficiently capitalized.
The entity’s total equity investment at risk is greater than, or equal to, other entities that hold only similar assets of similar quality and 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 amounts, and (2) without additional subordinated financings in its capital structure. For this reason, it is often difficult to demonstrate this condition exists when qualitatively assessing the sufficiency of total equity investment at risk.

Other non-equity sources of financing may demonstrate that an entity is sufficiently capitalized. Qualitative factors that may be useful in assessing the sufficiency of an entity’s equity investment at risk may include the following:

- The purpose and design of the entity
- The intentions of the parties that established the entity
- The credit rating of the entity
- The rate of interest the entity is required to pay to its lenders
- The terms of the company’s financing arrangements

Since debt may function as a surrogate for additional equity investments, the quality of the debt and associated interest rate are important factors to consider in this analysis. We believe that an entity’s 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 a potential VIE’s activities by absorbing a significant amount of the potential VIE’s expected losses. This assessment becomes more difficult when debt is not the only type of variable interest that may provide additional subordinated financial support. The existence of guarantees on the value of a potential VIE’s assets, put options allowing the equity investors to sell their interests at prices other than fair value, and similar arrangements are also variable interests that may also be a source of additional subordinated financial support. Such interests may also impact the quality of the debt that the potential VIE can procure.

Non-investment grade debt

The mere existence of subordinated debt (i.e., “high yield,” “mezzanine,” or “junk” debt) is not conclusive that an entity is thinly capitalized. If after considering the relevant facts and circumstances, a reporting entity is unable to conclude qualitatively that a potential VIE is sufficiently capitalized, a quantitative analysis would be required to determine whether Characteristic 1 is present. This quantitative analysis would compare the entity’s total equity investment at risk to the entity’s expected losses. If the results of this quantitative analysis demonstrate that the entity’s expected losses exceed the entity’s equity investment at risk, then the entity’s equity investment at risk is not sufficient and the entity would be a VIE.

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. If the guarantee was not necessary to receive the financing under the terms provided, the bank would not have negotiated for such a guarantee, or the equity investors would not have been willing to provide the guarantee.

**SPEs**

Typically in SPEs, other arrangements with the entity or other parties associated with the entity, as opposed to the holders of investments in equity at risk, bear most of the risk of loss related to the entity’s activities and often receive most of the residual benefit of the SPE’s activities. These other arrangements function in a manner that is often associated with an equity investment.

SPEs that are structured in such a manner will often be VIEs because the equity investment at risk will be insufficient. Such entities will likely be insufficiently capitalized because their total equity investment at risk does not exceed the entity’s expected losses.

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

An equity investment that is issued in return for an obligation to provide additional capital in the future is generally not considered equity at risk. The receivable recorded by the potential VIE is typically recorded as an offset (i.e., reduction) to GAAP equity, thereby reducing the total equity investment at risk. In addition, an entity may be thinly capitalized (and therefore a VIE) if an investor is obligated to fund the potential VIE’s activities on an ongoing basis (i.e., “step” funding arrangements).

**Commitments to finance future acquisitions**

In some cases, a potential VIE’s equity investors may agree to finance future acquisitions as part of the potential VIE’s strategy or business plan. This agreement to finance future acquisitions does not necessarily mean that an entity is insufficiently capitalized. Rather, if an entity is currently able to operate its business with equity that is currently deemed to be sufficient, the fact that the entity has an agreement with its equity investors to finance future acquisitions does not cause the entity to be insufficiently capitalized. However, care and judgment should be exercised to ensure that the future acquisitions are not currently needed to operate the business in its current state. In addition, an entity’s current ability to independently finance its operations without additional subordinated financial support from its equity investors should be considered. For example, if an entity is currently able to finance its operations with investment grade debt, it would not be considered insufficiently capitalized even if it has an agreement with its equity investors to finance future acquisitions.

Example 2-18 illustrates the determination of whether commitments to fund future acquisitions demonstrate that an entity is thinly capitalized.

**EXAMPLE 2-18**

Determining whether commitments to fund future acquisitions demonstrate that an entity is thinly capitalized

Company A forms Company X and contributes an existing business that provides services to retail and business consumers with a fair value of $1 million. The contributed business is in the mature phase of the business life cycle and finances its activities through cash flows generated from its operations. Company X’s capital structure is comprised entirely of common equity.
Company B, a financial investor, contributes $500 thousand to Company X in exchange for a 50% equity interest. Company B’s cash contribution is immediately distributed to Company A, resulting in an equalization of each party’s contribution to Company X.

The business plan of Company X contemplates the acquisition of other similar service businesses, with the intention of growing Company X through acquisition and exiting through a sale or initial public offering. Company A and Company B jointly agreed to fund the acquisition of each target company identified when and if the acquisition closes. Company A and Company B will each fund their respective share of the purchase price in proportion to their relative ownership interest in Company X (i.e., 50/50).

Should Company A and Company B’s contingent commitment to fund future acquisitions result in the conclusion that Company X is insufficiently capitalized as of the formation date?

**Analysis**

No. Company A’s evaluation of the sufficiency of Company X’s equity at risk should be based on whether Company X requires additional subordinated financial support to finance its current activities as of the date the analysis is performed. We do not believe contingent commitments to finance future acquisitions should lead to the conclusion that Company X is insufficiently capitalized in isolation. This view is premised on the notion that an investor’s commitment to finance future acquisitions is different from a commitment to finance an entity’s current activities. The decision to acquire a group of assets or a business represents an action that is ordinarily outside the normal course of business for an operating entity. We believe this differs from situations where an investor commits to provide additional capital to finance an entity’s current activities or to fund normal course capital expenditures.

Determining whether such commitments cause an entity to be a VIE under Characteristic 1 requires judgment. This analysis should be based on the entity’s particular facts and circumstances and consider the entity’s purpose and design.

**Development stage entities**

As a result of ASU 2014-10, *Development Stage Entities (Topic 915) – Elimination of Certain Financial Reporting Requirements, Including an Amendment to Variable Interest Entities Guidance in Topic 810*, the concept of a development stage entity was eliminated from the accounting literature. Prior to ASU 2014-10, relief existed for investors in development stage entities when evaluating if those entities have insufficient equity investment at risk. If a development stage entity had sufficient equity to finance the current stage of operations, it was not deemed to be a VIE under this characteristic. The amendments in ASU 2014-10 require that the determination of whether a reporting entity has sufficient equity at risk to fund operations contemplate both the current and ongoing stages of operations.

**Quantitatively demonstrating that the equity investment at risk is sufficient**

If the reporting entity is unable to qualitatively overcome the presumption that the potential VIE is insufficiently capitalized, the quantitative analysis described in ASC 810-10-25-45(c) would be required to conclude when the entity is sufficiently capitalized. This quantitative approach, which can be costly and time consuming, particularly for operating entities, requires a reporting entity to project
the potential VIE’s operating results and expected cash flows well into the future. The entity’s expected losses should then be compared to the total equity investment at risk to assess the sufficiency of the total equity investment at risk. If the entity’s total equity investment at risk is less than the entity’s expected losses, the entity would be considered insufficiently capitalized and therefore a VIE under Characteristic 1.

2.3.3.2 VIE characteristic 2: equity lacks decision making rights

The second characteristic of a VIE focuses on whether the “at risk” equity investors have the ability to make decisions that significantly impact the economic performance of the potential VIE. The underlying principle of Characteristic 2 is that if the equity investors lack the power to direct the activities that have the most significant impact on the economic performance of the entity, it can be inferred that a party other than the equity investor(s) most likely controls the entity. In those circumstances, a consolidation model that focuses on relative voting rights may not be useful in identifying which party, if any, holds a controlling financial interest in the entity.

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

As a group the holders of the equity investment at risk lack any one of the following three characteristics:

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

A reporting entity must determine whether Characteristic 2 exists, in addition to each of the other four characteristics of a VIE, when it holds a variable interest in a VIE that does not qualify for a VIE scope exception. When determining whether Characteristic 2 is present for entities other than limited partnerships, the following tasks should be performed:

□ Identify the capital contributions (i.e., equity investments) that qualify as equity investment at risk.

□ Group those equity investments together as if they were held by a single party.

□ Identify the entity’s most significant activities. This analysis should focus on those activities that significantly impact the entity’s economic performance.

□ Evaluate whether the holders of equity at risk, as a group, have the power, through voting rights or similar rights, to direct the entity’s most significant activities.

□ If decision making has been outsourced to one of the at-risk equity investors through a separate variable interest that does not qualify as equity at risk, determine whether the decision making rights conveyed through that other variable interest are embedded in the investor’s equity investment.

□ If the holders of equity at risk, as a group, lack rights that constrain the decision maker’s level of authority, consider whether a single party has substantive kick-out or participating rights over the decision maker.
Applying Characteristic 2 to limited partnerships and similar entities

A separate analysis is required for applying Characteristic 2 to limited partnerships and similar entities due to the unique purpose and design of limited partnerships as compared to corporations. Entities that are determined to be “similar” to limited partnerships would also be subject to this requirement. For example, some entities may be similar to a limited partnership if they have a governance structure that is the functional equivalent of a limited partnership’s governance structure.

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

ii. For limited partnerships, partners lack that power if neither (01) nor (02) below exists. The guidance in this subparagraph does not apply to entities in industries (see paragraphs 910-10-45-1 and 932-810-45-1) in which it is appropriate for a general partner to use the pro rata method of consolidation for its investment in a limited partnership (see paragraph 810-10-45-14).

01. A simple majority or lower threshold of limited partners (including a single limited partner) with equity at risk is able to exercise substantive kick-out rights (according to their voting interest entity definition) through voting interests over the general partner(s).

A. For purposes of evaluating the threshold in (01) above, a general partner’s kick-out rights held through voting interests shall not be included. Kick-out rights through voting interests held by entities under common control with the general partner or other parties acting on behalf of the general partner also shall not be included.

02. Limited partners with equity at risk are able to exercise substantive participating rights (according to their voting interest entity definition) over the general partner(s).

03. For purposes of (01) and (02) above, evaluation of the substantiveness of participating rights and kick-out rights shall be based on the guidance included in paragraphs 810-10-25-2 through 25-14C.

Evaluating whether an entity is similar to a limited partnership

To understand whether an entity’s governance structure is similar to a limited partnership, an analysis should be performed based on the facts and circumstances specific to that entity’s formation and governing documents. For example, a limited liability company that is governed by a managing member, as opposed to a board of managers, may be similar to a limited partnership. The evaluation of a limited liability company should consider whether a managing member has sole decision making authority, similar to the rights held by the general partner of a limited partnership.

Question 2-4 addresses whether the separate requirement for limited partnerships and similar entities should be applied when evaluating whether a trust is a VIE under Characteristic 2.
Question 2-4
Should the separate requirement described in ASC 810-10-15-14(b)(1)(ii) for limited partnerships and similar entities be applied when evaluating whether a trust is a VIE under Characteristic 2?

PwC response
It depends. If the trust is governed by a single trustee that has been granted all day-to-day decision making abilities, then application of the separate requirement for limited partnerships and similar entities may be appropriate. In that situation, the trustee may be acting in a capacity that is no different from a general partner of a limited partnership.

If the trust is governed by a board of trustees that has the legal ability to make decisions and bind the trust, and the trustee is simply acting as an agent of the trust’s board, then application of the separate requirement applicable to limited partnerships and similar entities may be inappropriate.

Determining whether a trust is governed by a single trustee or a governing body that is similar to a board of directors requires a review of the trust’s governing documents. If a board of trustees exists, it is important to understand whether the board’s decision making rights are limited to advising the trustee as opposed to having the legal authority to bind the trust. If the board’s role is limited to advising the trustee (i.e., it cannot bind the trust), then application of the separate requirement for limited partnerships and similar entities may be appropriate.

A limited liability company may be governed by a board of members as opposed to a managing member. Much like a corporation’s board of directors, the entity’s board of members votes on all significant decisions impacting the limited liability company’s activities. An evaluation of the limited liability company might consider whether the members have capital accounts similar to limited partners of a limited partnership. This analysis would also take into account what decision making rights have been granted to the members and how their voting rights are exercised.

Example 2-19 demonstrate the determination of whether a limited liability company is similar to a limited partnership.

EXAMPLE 2-19
Determining whether a limited liability company is similar to a limited partnership

Company A established a limited liability company (LLC Corp) for the purpose of raising third party capital to invest in private companies. LLC Corp’s objective is to obtain controlling positions in private companies, improve the performance of the businesses, and liquidate its position within seven years. The third party investors are issued member interests in LLC Corp in exchange for their capital contributions. Each member has a separate capital account, and LLC Corp’s profits and losses are allocated among the members based on their proportionate ownership of the LLC’s member interests.

LLC Corp is presided over by Company A (the Managing Member). In its capacity as Managing Member of LLC Corp, Company A makes all decisions related to LLC Corp’s investment strategy, and also makes decisions pertaining to the acquisition and disposition of LLC Corp’s investments. Company A established an independent committee (the Investment Committee) comprised of certain members to advise Company A; however, the Investment Committee may not bind LLC Corp as its role is purely advisory in nature. The Investment Committee can, however, vote on transactions
involving Company A and its affiliates where a conflict of interest may exist. The members of LLC Corp are not otherwise able to exercise any voting rights.

For purposes of applying Characteristic 2, should LLC Corp be evaluated as a limited partnership or as a corporation?

**Analysis**

We believe that if a managing member has the right to make the significant decisions of the LLC, the LLC would be considered as having governing provisions that are the functional equivalent of a limited partnership. This is the case even if the non-managing members have participating rights or kick-out rights. While the ASC guidance states that a managing member of an LLC is the functional equivalent of a general partner, we believe the managing member also needs to have the right to make the significant decisions of the LLC for the LLC to have governing provisions that are the functional equivalent of a limited partnership (versus a managing member who may be more of an operations manager without the right to make the significant decisions of the entity).

In this example, LLC Corp should be evaluated as a limited partnership for purposes of applying Characteristic 2, as it has a managing member who has the right to make all the significant decisions of the LLC.

Company A is the only party authorized to make decisions and to bind LLC Corp, similar to a general partner of a limited partnership. Although the Investment Committee exists, it does not operate in a manner similar to a corporation’s board of directors. The Investment Committee exists solely to advise Company A and cannot bind the LLC, and its ability to vote on transactions involving Company A and its affiliates is protective in nature and exists solely to prevent self-dealing.

In addition, LLC Corp’s members have capital accounts as opposed to ownership units, which also indicates that LLC Corp has attributes that are like a partnership.

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**Determining whether the limited partners lack the power to direct the entity’s most significant activities**

For limited partnerships, Characteristic 2 (ASC 810-10-15-14(b)(1)) has a separate requirement specific to limited partnerships and similar entities that must be met in order to demonstrate limited partners lack power over those entities. This requirement is based on the unique purpose and design of limited partnerships as compared to corporations.

Understanding the principle behind this guidance requires consideration of the differences between a limited partnership and a traditional corporation. A corporation’s shareholders generally have voting rights that provide them with the power to direct the entity’s most significant activities. Although the corporation’s management team executes the day-to-day decisions, the voting rights held by the corporation’s shareholders allow the shareholders to limit or constrain the management team’s decision making authority.

In contrast, the general partner of a limited partnership often unilaterally directs the activities of a limited partnership that most significantly impact the entity’s economic performance. Although the limited partners generally lack voting rights consistent with those rights typically held by corporate shareholders, they may have other rights that allow them to effectively constrain the general partner’s
decision making authority. Determining whether these rights exist is critical to assessing whether a limited partnership or similar entity is a VIE under Characteristic 2.

For a limited partnership (or similar entity) to be a voting interest entity, the limited partners (or members of a limited liability company that is similar to a limited partnership) must have, at minimum, substantive kick-out or participating rights. Any of these rights, if present, are considered analogous to voting rights held by corporate shareholders that provide those shareholders with power over the entity being evaluated for consolidation. In other words, the limited partnership (or similar entity) would not be a VIE under Characteristic 2 if substantive kick-out or participating rights exist.

**Determining whether kick-out rights are substantive**

The mere existence of kick-out rights does not necessarily demonstrate that the limited partners lack power over the limited partnership (or similar entity). The kick-out rights must be substantive to demonstrate that the group of at-risk equity investors (i.e., the limited partners) has power. Kick-out rights will be considered substantive only when they are exercisable by a simple majority vote of the entity’s limited partners (exclusive of the general partner, parties under common control with the general partner, and other parties acting on behalf of the general partner) or a lower threshold (as low as a single limited partner) based on the limited partners’ relative voting rights. A limited partner’s voting rights are often determined by its relative capital account balance.

The substance of kick-out rights granted to an entity’s limited partners may be called into question when there are economic or operational barriers to exercising such rights that must be overcome, for example:

- Conditions that make it unlikely that the rights will be exercised
- Financial penalties or operational barriers that the limited partners would face upon exercise of the kick-out right
- An inadequate number of qualified replacements for the current decision maker, or when the level of compensation paid to the decision maker is inadequate to attract a qualified replacement
- The lack of an explicit mechanism, by matter of contract or law, to allow the holder to exercise the rights or to obtain the information necessary to exercise the rights

Question 2-5 addresses the effect of a general partner and/or its related parties in a limited partnership having the right to participate in a vote to kick-out the general partner on the limited partnership’s status as a voting interest entity under Characteristic 2.

**Question 2-5**

Does the ability of a general partner and/or its related parties to participate in a vote to kick-out the general partner of a limited partnership preclude the limited partnership from being a voting interest entity under Characteristic 2?

**PwC response**

It depends. If a simple majority of the unrelated limited partners (or a lower threshold) lack the substantive right to remove the general partner, then the entity would be considered a VIE under...
Characteristic 2. For example, if an entity has 12 partners, including the general partner, 10 of which are unrelated limited partners that own equal interests in the limited partnership, a provision that called for a vote of six of the 10 unrelated limited partners to remove the general partner would demonstrate that the limited partners do not lack power under Characteristic 2. This would be the case even if the ten limited partners held less than 50% of the outstanding limited partnership interests, collectively.

If, on the other hand, the limited partnership required a vote of a simple majority of all 12 partners (i.e., 7 partners) to remove the general partner, this right would not be substantive because a simple majority of the unrelated LPs (6 in this example) would be unable to effect the removal.

**Evaluating the impact of participating rights**

Substantive participating rights held by limited partners would also demonstrate that the partnership is a voting interest entity under Characteristic 2. A participating right allows the holder to veto or block a significant decision of an entity being evaluated for consolidation.

Unlike a kick-out right, a participating right does not convey power since it does not allow the holder to *initiate* the action or decision. A participating right allows the holder to *prevent* another party from exercising power over a decision or significant activity of the potential VIE.

Determining whether a participating right is substantive requires consideration of the decisions or activities that the holder of the participating right may block (veto). The threshold, or level of decisions or activities the holder must be able to block (veto) to demonstrate that a participating right is substantive, varies depending upon the nature of the entity and the consolidation model being applied.

A participating right has historically been substantive in the VIE model only if the holder had the ability to block (veto) all of the entity’s most significant activities. In contrast, a participating right is substantive in the voting model if the holder has the ability to prevent a majority owner from making a single significant, ordinary course financial or operating decision of the entity.

Participating rights over a limited partnership or similar entity are evaluated differently from all other entities when determining whether Characteristic 2 is present. The threshold established by the voting interest model to assess whether a participating right is substantive should be applied when determining whether a limited partnership or similar entity is a VIE under Characteristic 2. ASC 810-10-25-5 defines a participating right as the right to block or participate in significant financial and operating decisions that are made in the ordinary course of business. As such, a limited partnership or similar entity would not be a VIE under Characteristic 2 if the limited partners have the ability to block at least one significant operating or financial decision made in the ordinary course of business.

**Evaluating the impact of liquidation rights**

Often times a partnership’s governing documents provide its limited partners with the right to liquidate the partnership without cause. Kick-out rights include both removal *and* liquidation rights. Liquidation rights provide the holder(s) with the ability to effectively remove the entity’s decision maker by dissolving the entity.

The outcome for the decision maker will be the same regardless of whether it is kicked-out or the entity is liquidated (i.e., it will be stripped of its ability to exercise power).
If the group of at-risk equity investors has the ability to liquidate a partnership, that liquidation right must be substantive to demonstrate that Characteristic 2 is not present. Specifically, reporting entities should consider whether the limited partners would be subject to financial or operational barriers that would act as a disincentive to exercising the liquidation right. In addition, the reporting entity should consider whether a reasonable mechanism exists to allow the unrelated limited partners to exercise the right.

Liquidation rights would not be substantive when operational or financial barriers exist that would disincentivize the unrelated limited partners from exercising the right. A liquidation right would not be substantive if the unrelated limited partners lack an explicit mechanism to exercise the liquidation right, for example, when they are unable to obtain the identities of the other limited partners to convene a general meeting and/or when they lack the ability to call a general meeting.

**Evaluating the impact of redemption rights**

With very limited exceptions, redemption rights held by the limited partners of a partnership should not be considered equivalent to kick-out or participation rights. A redemption right differs from a kick-out or liquidation right legally and economically.

Legally, an investor’s redemption of its interest does not provide the holder with the ability to remove the decision maker. Rather, it provides the investor with the ability to liquidate its investment without impacting the decision maker’s ability to make ongoing decisions. In other words, a redemption right is simply a liquidity feature inherent in the investor’s equity interest as opposed to a right to remove the decision maker.

There may be instances where a limited partnership or similar entity has a single investor who has the right to redeem its interest at any time. We believe the facts and circumstances of those situations should be carefully considered to determine whether the single investor’s ability to redeem its interest should be viewed as a substantive liquidation right. If the redemption of the investor’s interest would result in a liquidation of the entity, or the termination of all substantive operating activity within the entity, then that redemption right may be no different than a liquidation right.

Example 2-20 illustrates the determination of whether a redemption right represents an in-substance liquidation right.

**EXAMPLE 2-20**

**Determining whether a redemption right represents an in-substance liquidation right**

Company A established a limited liability company (LLC Corp) for the purpose of raising third party capital to invest in liquid publicly listed securities. LLC Corp’s objective is to acquire and hold undervalued securities and then to dispose of them on an opportunistic basis.

A single investor, Company B, which is unrelated to Company A, holds 99.9% of LLC Corp’s member interests. Company B acquired its 99.9% member interest in exchange for cash. Company A, LLC Corp’s Managing Member, holds the remaining 0.1% equity interest, which it acquired in exchange for a nominal cash contribution. LLC Corp is similar to a limited partnership from both a governance and ownership perspective (i.e., not governed by a board of directors and its members have separate capital accounts).
Company B has the ability to redeem its interest in LLC Corp at any time. If Company B redeems its interest and LLC Corp has no other members, then Company A is required to wind down LLC Corp’s operations. Company B is not otherwise able to liquidate LLC Corp or replace Company A as LLC Corp’s Managing Member.

Does Company B’s ability to redeem its interest represent an in-substance liquidation right?

**Analysis**

Yes. Since Company B is the sole member of LLC Corp, and LLC Corp is required to wind down its operations if Company B exercises its redemption right, this is no different than Company B having the ability to unilaterally liquidate LLC Corp. Because Company B has the ability to strip Company A of its decision making rights as Managing Member of LLC Corp upon exercising its redemption right, Characteristic 2 is not present and LLC Corp is not a VIE under ASC 810-10-15-14(b)(1)(i).

**Outsourced decision making arrangements**

In some cases, determining whether power is held by the general partner or another party can be challenging. This is particularly true when there are separate management contracts held by the general partner’s related parties. In such instances, the following questions should be considered:

- **What is the ownership structure of/relationship between the general partner (managing member) and the related party that holds the investment management agreement (i.e., are the entities commonly controlled)?** In the event that the general partner and the related party are under common control, and the substance of the arrangement is that the investment decisions are effectively made by the general partner (due to the common control relationship of the related party and the general partner), it could be inferred that the significant decision making rights reside with the general partner.

- **Does the general partner have the legal right to sell/transfer its decision making rights to an unrelated entity?** If the general partner transfers its general partnership interest to a third party, the right to appoint the manager automatically also transfers to the third party. This would be indicative of the decision making rights residing in the GP interest.

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

If, after considering the factors described above, it is determined that the outsourced decision maker has substantive decision making rights (as opposed to the general partner), then the limited partners must have substantive kick-out or participating rights over the outsourced decision maker. Otherwise, Characteristic 2 will be present and the limited partnership will be a VIE.

**Applying Characteristic 2 to all other entities**
Excerpt from ASC 810-10-15-14(b)

As a group the holders of the equity investment at risk lack any one of the following three characteristics:

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

i. For legal entities other than limited partnerships, investors lack that power through voting rights or similar rights if no owners hold voting rights or similar rights (such as those of a common shareholder in a corporation). Legal entities that are not controlled by the holder of a majority voting interest because of noncontrolling shareholder veto rights (participating rights) as discussed in paragraphs 810-10-25-2 through 25-14 are not VIEs if the holders of the equity investment at risk as a group have the power to control the entity and the equity investment meets the other requirements of the Variable Interest Entities Subsections.

01. If no owners hold voting rights or similar rights (such as those of a common shareholder in a corporation) over the activities of a legal entity that most significantly impact the entity’s economic performance, kick-out rights or participating rights (according to their VIE definitions) held by the holders of the equity investment at risk shall not prevent interests other than the equity investment from having this characteristic unless a single equity holder (including its related parties and de facto agents) has the unilateral ability to exercise such rights. Alternatively, interests other than the equity investment at risk that provide the holders of those interests with kick-out rights or participating rights shall not prevent the equity holders from having this characteristic unless a single reporting entity (including its related parties and de facto agents) has the unilateral ability to exercise those rights. A decision maker also shall not prevent the equity holders from having this characteristic unless the fees paid to the decision maker represent a variable interest based on paragraphs 810-10-55-37 through 55-38.

Characteristic 2 also applies to entities other than limited partnerships (e.g., entities governed by a board of directors, such as corporations). The application of Characteristic 2 to all other entities centers on whether the holders of equity at risk, as a group, have rights (through their equity interests) to direct the activities of the entity that most significantly impact its economic performance.

How to evaluate whether the equity holders as a group lack power

Determining which activities most significantly impact the entity’s economic performance requires judgment. When an entity’s operations are straightforward or one dimensional, determining whether or not the holders of the equity investment at risk meet the power criterion may not require significant judgment.

In other cases, this analysis may not be so clear cut. The identification of the entity’s significant activities may require consideration of the entity’s purpose and design, specifically, the nature of the entity’s activities and the risks it was designed to create and pass along to its variable interest holders. Reporting entities should carefully review the entity’s governing documents, contractual arrangements the entity has entered into, the entity’s website and/or promotional materials describing the nature of its operations, as well as the terms of the interests it has issued to its investors. A careful review of these arrangements should facilitate the identification of the potential VIE’s significant activities as well as the party that has the power to direct those activities.
Identifying an entity’s most significant activities

Identifying the activities of a potential VIE that most significantly impact its economic performance, and assessing how decisions related to those activities could affect the economic performance of the entity, is critical when assessing whether Characteristic 2 is present. Once the entity’s significant activities are identified, it is important to determine whether the decisions related to those activities are made by the group of holders of equity at risk or by parties outside of that group.

The identification of an entity’s most significant activities should focus on those activities that require decisions to be made that meaningfully impact the entity’s key operating metrics and/or business strategy. In other words, those decisions should be substantive.

The activities of an entity that most significantly impact an entity’s economic performance will vary by industry depending on the nature of the entity’s operations. Certain decisions may universally represent a significant activity of an entity, such as negotiating and executing significant acquisitions and strategic alliances, purchasing or selling assets, expanding the entity’s service or product offering, selecting management and determining their compensation, establishing, executing and approving capital and operating budgets, and capital financing (i.e., the issuance of debt or equity).

Other significant activities will be heavily influenced by the nature of the entity’s operations. The following list provides examples of activities that may represent some of the activities that most significantly impact the economic performance of entities operating within those industries:

<table>
<thead>
<tr>
<th>Industry</th>
<th>Examples of significant activities</th>
</tr>
</thead>
</table>
| Financial services – asset management | □ Establishing the entity’s investment strategy  
□ Purchases and sales of underlying investments  
□ Exercising voting rights over investees  
□ Negotiating key service provider contracts |
| Financial services – securitization vehicles | □ Identifying, negotiating, and purchasing assets held as collateral  
□ Servicing or “working out” loans or other assets held as collateral that are delinquent or in default |
| Financial services – banking | □ Extending credit / lending standards  
□ Decisions to extend loans to borrowers  
□ Investing surplus cash  
□ Establishing and executing the risk management strategy of the bank  
□ Servicing or “working out” loans or other assets held as collateral that are delinquent or in default |
| Financial services – insurance | □ Underwriting insurance policies  
□ Ceding insurance to reinsurers  
□ Investing net written premiums received |
<table>
<thead>
<tr>
<th>Industry</th>
<th>Examples of significant activities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Broadcasting (television and radio)</td>
<td>□ Negotiating retransmission agreements</td>
</tr>
<tr>
<td></td>
<td>□ Programming</td>
</tr>
<tr>
<td></td>
<td>□ Advertising</td>
</tr>
<tr>
<td>BioPharma and technology</td>
<td>□ Varies depending upon the phase of the entity’s life cycle, although the significant activities over the entity’s life may be:</td>
</tr>
<tr>
<td></td>
<td>□ Research and development</td>
</tr>
<tr>
<td></td>
<td>□ Sales and marketing (i.e., commercialization of approved drug compounds / biologics / new technologies)</td>
</tr>
<tr>
<td></td>
<td>□ Manufacturing of the drug, biologic, or technology</td>
</tr>
<tr>
<td></td>
<td>□ The power assessment may require a reporting entity to consider whether the stages of the entity’s life cycle are sequenced and dependent upon each other (i.e., whether there is uncertainty around the entity’s ability to progress from one stage of its life cycle to another)</td>
</tr>
<tr>
<td></td>
<td>□ If the stages of its life cycle are dependent upon one another, the entity’s most important activities will change as it progresses through its life cycle</td>
</tr>
<tr>
<td>Retail, consumer and industrial products</td>
<td>□ New product development</td>
</tr>
<tr>
<td></td>
<td>□ Negotiating supply contracts</td>
</tr>
<tr>
<td></td>
<td>□ Manufacturing (e.g., determining quantities of product sold and sourcing of raw material / inputs to production)</td>
</tr>
<tr>
<td></td>
<td>□ Sales and marketing</td>
</tr>
<tr>
<td>Healthcare (provider)</td>
<td>□ Negotiating provider and payor contracts</td>
</tr>
<tr>
<td></td>
<td>□ Employment and compensation decisions (both clinical and non-clinical)</td>
</tr>
<tr>
<td></td>
<td>□ Establishing patient care policies and protocol</td>
</tr>
<tr>
<td></td>
<td>□ Providing patient care</td>
</tr>
<tr>
<td>Real estate (leasing)</td>
<td>□ Selection of tenants</td>
</tr>
<tr>
<td></td>
<td>□ Establishing lease terms, including rental rates</td>
</tr>
<tr>
<td></td>
<td>□ Maintaining the property</td>
</tr>
<tr>
<td></td>
<td>□ Capital expenditures</td>
</tr>
<tr>
<td></td>
<td>□ Managing the residual value of the property</td>
</tr>
<tr>
<td>Power and utilities (power plants)</td>
<td>□ Varies depending upon the phase of the power plant’s life cycle (refer to UP 10.4.1.2)</td>
</tr>
</tbody>
</table>
The list presented above is not all inclusive and is intended to provide examples of activities that may significantly impact an entity’s economic performance. Reporting entities should evaluate the specific facts and circumstances of each individual situation when identifying a potential VIE’s significant activities.

Decisions that are purely administrative in nature should not be considered a significant activity of an entity. Back office functions that do not meaningfully impact an entity’s overall performance generally should not be considered a significant activity of a potential VIE. For example, accounting, information technology, and human resource functions would generally not be considered a significant activity of a normal operating entity when determining whether the group of at-risk equity investors has the power to direct the entity’s most significant activities.

**Evaluating entities with limited ongoing decision making**

Sometimes an entity’s activities are predetermined at formation and the level of ongoing decision making required is limited. Determining whether such entities are VIEs requires careful consideration of the relevant facts and circumstances, including the entity’s purpose and design.

If the entity’s ongoing decisions are purely administrative in nature, we believe Characteristic 2 would not be present since the group of at-risk equity investors predetermined the entity’s significant activities at formation. Even if the ongoing decisions are made through a variable interest that does not qualify as equity at risk, Characteristic 2 would not be present if those ongoing decisions are insignificant or administrative. In that situation, the decision maker would be unable to direct a single activity of the potential VIE that significantly impacts its economic performance.

When the entity’s ongoing decisions are other than purely administrative, we believe the identity of the party directing those activities and the means through which it exercises decision making becomes increasingly relevant. If those ongoing decisions are directed through a variable interest that does not qualify as equity at risk (refer to **Decision making must reside within the equity instrument** in the next section), the nature of the ongoing decisions made by the holder of that variable interest should be carefully considered to determine whether the group of at-risk equity investors lack power.

**Decision making must reside within the equity instrument**

**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.

In some circumstances, a holder of equity at risk may have the ability to make decisions through another variable interest (e.g., decision making arrangement, such as a management contract) as opposed to an at-risk equity investment. If these decisions are made through another variable interest as opposed to the decision maker’s at-risk equity investment, then depending on the facts those rights may not be attributed to the group of at-risk equity investors for purposes of assessing whether Characteristic 2 is present. Consequently, the entity may be considered a VIE.

Determining whether decision making rights are held by the group of holders of equity at risk can be difficult, particularly when one of the equity investors has entered into a separate contractual
arrangement with the potential VIE that conveys decision making rights. If the decision maker can sell its equity interest to an unrelated third party, it should consider whether the buyer (transferee) would also be required to purchase or assume the reporting entity’s other variable interest (the decision making arrangement). In other words, the decision maker should determine whether the variable interest that conveys decision making is legally detachable from its at-risk equity investment.

If the other variable interest (e.g., decision maker contract) can be legally separated from the decision maker’s equity investment, we believe the contractual arrangement and at-risk equity investment should be evaluated as two distinct interests. To make this determination, a reporting entity should consider whether it is possible for the decision maker to transfer its equity interest without also transferring its other variable interest that conveys decision making rights. If it is not legally possible to separate the variable interests, then the power to direct the entity’s most significant activities may reside within the group of at-risk equity investors. In other words, the decisions making rights exercisable through its other variable interest may be viewed as though they are exercised through the decision maker’s equity interest (i.e., the contractual arrangement would be considered part of the decision maker’s equity interest). Consequently, no decision making exception would be present and the entity would not be a VIE with respect to Characteristic 2.

If the two variable interests are legally separable and decision making is exercisable through the contractual arrangement, further analysis is required to determine whether the entity is a VIE under Characteristic 2. This would require consideration of the rights exercisable by the potential VIE’s at-risk equity investors. Refer to the next section, Assessing whether the equity investors lack power when decision making has been outsourced for further details.

Assessing whether the equity investors lack power when decision making has been outsourced

If a variable interest that is outside the equity investment at risk (e.g., debt interests, management contracts and equity investments that do not qualify as equity at risk) provides the holder of that interest with the power to direct the activities that most significantly impact the potential VIE’s economic performance, then Characteristic 2 may be present and the entity could be considered a VIE.

ASU 2015-02, Consolidation – Amendments to the Consolidation Analysis, issued in February 2015, changed the evaluation of whether the at-risk equity investors (as a group) lack power when decision making is outsourced through a variable interest that does not qualify as equity at risk. In particular, the changes apply if there is a single decision maker that has a variable interest that is separate from (not embedded in) a substantive at-risk equity investment that conveys the power to direct the entity’s most significant activities. If the interest conveying decision making is not a variable interest, then the group of at-risk equity investors are presumed to have the power to direct the entity’s most significant activities and Characteristic 2 would not be present.

The change in how outsourced activities should be assessed resulted from the FASB’s consideration during the redeliberations of ASU 2015-02 of whether a registered mutual fund should be a VIE. Prior to the issuance of ASU 2015-02, a registered mutual fund would have been considered a VIE under the “power” and “economics” version of the VIE model if (1) an outsourced decision maker had power through a variable interest that was not embedded in an at-risk equity investment, and (2) substantive kick-out or participating rights exercisable by a single party did not exist.

The FASB considered the rights exercisable by the shareholders and board of directors of a mutual fund that is registered in accordance with the Investment Company Act of 1940 and determined that
these entities should generally be considered voting interest entities. Specifically, the FASB noted that the rights exercisable by a registered mutual fund’s shareholders, either directly or indirectly through the entity’s independent board of directors, are not substantively different from voting rights held by shareholders of a public company (which are generally not VIEs).

The new approach introduced by ASU 2015-02 shifts the focus from single party kick-out or participating rights to the rights that the entity’s shareholders can exercise in the aggregate. If such rights exist and are substantive, it is presumed that the shareholders can constrain the outsourced decision maker’s level of discretion and decision making authority. Application of this approach may result in the conclusion that the shareholders, rather than the outsourced decisions maker (e.g., manager), have the power to direct an entity’s most significant activities.

Although this concept was discussed in the context of a registered mutual fund, it applies to all entities that outsource decision making through variable interests that do not qualify as equity at risk (e.g., management contracts or equity interests that do not qualify as equity at risk). This approach should not be applied to limited partnerships and similar entities as those entities are subject to the separate requirement described in ASC 810-10-15-14(b)(1)(ii).

The new approach described in ASC 810-10-15-14(b)(1)(i), which applies to entities that are not limited partnerships or similar entities, can be summarized in the following three steps.

**Step 1: determine if the decision-making fee arrangement is a variable interest**

If the decision-making fee arrangement is not a variable interest, then the equity investors as a group do not lack the power to direct the activities of the entity that most significantly impact its economic performance. The nature of that arrangement would indicate that the decision maker is acting in a fiduciary (agent) capacity and is therefore presumed to lack power over the entity’s most significant activities. This is because the decision maker will act in a manner that is primarily for the benefit of the entity’s equity investors. As a result, the entity would not be a VIE under Characteristic 2 and steps two and three would not apply.

Example 2-21 illustrates the assessment of the impact of a decision-making fee arrangement that is not a variable interest.

**EXAMPLE 2-21**

Assessing the impact of a decision-making fee arrangement that is not a variable interest

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% of the time. Otherwise, Entity ABC would be subject to payment of heavy penalties.

Company A provides maintenance services to Entity ABC that are critical to the data center’s operations. Under the maintenance arrangement, Company A makes all decisions related to the maintenance of the data centers and keeps them operational pursuant to the contractual requirements. Company A 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 Company A is not a variable interest (i.e., Company A’s fee is at market,
commensurate, and Company A has no other economic interests directly or indirectly through its related parties that are more than insignificant).

What is the impact of Company A’s ability to make decisions through its service provider arrangement?

**Analysis**

In this example, even though Company A makes critical decisions that have a significant impact on the performance of Entity ABC, the maintenance fee is not a variable interest and Entity ABC would not be a VIE under Characteristic 2. If a decision maker or service provider contract is not a variable interest (see CG 2.2.4), then the decision maker or service provider is acting as an agent of the group of holders of equity at risk and would not have the power to direct Entity ABC’s most significant activities.

**Step 2: determine if there is a unilateral kick-out or participating right**

If the decision-making fee arrangement is a variable interest under the first step, then the reporting entity should consider whether substantive kick-out or participating rights exist. If a substantive right to replace the decision maker or veto (block) all of the entity’s most significant activities exists, then the entity would not be a VIE under Characteristic 2 and step 3 would not apply.

For the purposes of assessing whether a kick-out right or participating rights are substantive when evaluating an entity that is not a limited partnership or similar entity, kick-out rights (which also include liquidation rights) and participating rights should be ignored unless those rights can be exercised by a single party (including its related parties and de facto agents).

**Step 3: assess the rights of shareholders**

If the decision-making fee is determined to be a variable interest pursuant to ASC 810-10-55-37, and single party kick-out or participating rights do not exist, then the rights held by the entity’s equity investors must be considered to determine whether the at risk equity investors, as a group, lack the power to direct the entity’s most significant activities. Prior to the issuance of ASU 2015-02, the group of at risk equity investors was not considered to have power if a decision maker exercised power over the entity’s most significant activities through a variable interest that did not qualify as equity at risk. In such circumstances, the entity was determined to be a VIE under Characteristic 2 unless a single party (including its related parties and de facto agents) could exercise a substantive kick-out or participating right.

ASU 2015-02 introduced a new approach requiring a reporting entity to first consider the rights exercisable by the holders of equity at risk if substantive single party kick-out or participating rights do not exist. This additional step is required only when decision making over an entity’s most significant activities has been conveyed through a variable interest that does not qualify as equity investment at risk and single party kick-out or participating rights do not exist. If the at risk equity investors have certain rights as shareholders of the entity, then the entity would not be a VIE.

ASC 810-10-55-8A provides an example to illustrate the types of rights that may suggest the holders of equity at risk, as a group, have decision making power over the entity’s most significant activities. The example is written in the context of a series mutual fund and points to various shareholder rights as being present, including the ability to remove and replace the board members and the decision maker,
and to vote on the decision maker’s compensation. It should also be noted that ASU 2015-02’s basis for conclusions (BC36) notes that this concept is intended to be applied broadly to all entities other than limited partnerships and similar entities.

Example 2-22 illustrates the application of this concept in a non-fund scenario.

**EXAMPLE 2-22**

Determining whether rights held by an entity’s shareholders convey power

Three unrelated companies established an entity to invest in shipping vessels. Company A and B each provide 40% of the capital in exchange for equity interests, and Company C also provides capital in exchange for a 20% equity interest. The entity operates subject to the supervision and authority of its board of directors. Each party has the ability to appoint members to serve on the entity’s board and shares in the entity’s profits and losses in proportion to their respective ownership interests.

The purpose, objective, and strategy of the entity is established at inception and agreed upon by its shareholders pursuant to the entity’s formation agreements. The three companies identified and jointly agreed to the specified shipping vessels in which the entity would invest at formation.

Company C performs all of the daily operating and maintenance activities over the shipping vessels pursuant to an Operating and Maintenance (O&M) agreement. The decisions relating to the operation and maintenance of the vessels are determined to be activities of the entity that most significantly impact the entity’s economic performance. Company C receives a fixed annual fee for services provided to the entity that is at market and commensurate. However, the fee arrangement is determined to be a variable interest because Company C has another significant variable interest in the entity (its 20% equity investment).

A number of decisions require simple majority board approval. These include:

- The removal and replacement of the O&M manager, without cause
- Changes in the O&M manager’s compensation
- The acquisition of new ships
- The sale of existing ships
- A merger and/or reorganization of the entity
- The liquidation or dissolution of the entity
- Amendments to the entity’s charter and by-laws
- Increasing the entity’s authorized number of common shares
- Approval of the entity’s periodic operating and capital budgets
Do the holders of equity at risk, as a group, lack the power to direct the entity’s most significant activities (is the entity a VIE under Characteristic 2)?

**Analysis**

Notwithstanding the fact that the decision-making fee arrangement is a variable interest, the entity would not be considered a VIE. The board is actively involved in making decisions about the activities that most significantly impact the entity’s economic performance. Among other rights, the board is able to remove the O&M manager without cause and approve its compensation. As the board is elected by the shareholders and is acting on their behalf, the shareholders in effect have power to direct the activities that most significantly impact the economic performance of the entity. Accordingly, the entity would not be a VIE under Characteristic 2.

If the board was non-substantive or lacked the legal authority to bind the entity, then the rights exercisable by the board would be less relevant. In that situation, the rights exercisable directly by the holders of equity at risk would determine whether the group lacks power.

Determining which shareholder rights must exist to demonstrate that Characteristic 2 is not present will depend on the relevant facts and circumstances, including the purpose and design of the entity. If an entity has a substantive board of directors, and the board is actively involved in overseeing the business and can legally bind the entity, we believe the at risk equity investors must have the ability to replace the board to demonstrate that they have power unless they have the substantive ability to directly exercise the same rights held by the board.

If an entity is not governed by a board of directors, or is governed by a board of directors that cannot legally bind the entity, then rights exercisable by the board become less relevant to this analysis. In those circumstances, rights exercisable by the shareholders (directly) should be assessed to determine whether they enable the holders of equity at risk, as a group, to constrain the outsourced decision maker’s level of authority and decision making.

Example 2-23 illustrates the determination of whether an at risk equity investor has power through an outsourced decision making arrangement.
EXAMPLE 2-23
Determining whether an at risk equity investor has power through an outsourced decision making arrangement

Two unrelated parties, Company A and Company B, form a real estate operating joint venture, with each party holding a 50% interest. The venture’s objective is to acquire properties, lease the properties to third party tenants, and sell the properties on an opportunistic basis.

The venture will be governed by a board of directors (the Board), and Company A and Company B will each be entitled to appoint three of the Board’s six directors. The Board will act through a simple majority vote and in the event of a deadlock, a dispute resolution mechanism will take effect to resolve the issue (binding arbitration).

The Board executed a property management agreement with Company B giving Company B the ability to unilaterally direct leasing, maintenance, tenant selection, and remarketing activities related to the properties owned by the venture (the venture’s most significant activities). The agreement has an initial one-year term and will automatically renew for successive one-year periods unless Company B or the Board elect not to renew the contract. In exchange for services provided, Company B will be entitled to an annual management fee and performance incentive fee entitling Company B to 15% of the venture’s profits once the investors achieve a 15% internal rate of return on their capital contributions. Otherwise, Company A and Company B will share in the profits and losses of the venture proportionately.

Notwithstanding the fact that the fee arrangement is at market and commensurate, Company B’s property management agreement is a separate variable interest given Company B’s other significant economic interest (i.e., its 50% equity interest). The decision making rights exercisable by Company B pursuant to the property management agreement were determined to be separate from its 50% equity investment (i.e., they are not embedded).

As shareholders of the venture, Company A and Company B have the ability to make the following decisions through a simple majority vote:

- Terminate the property management agreement
- Approve changes in Company B’s compensation
- Approve a sale of substantially all of the venture’s assets
Variable interest entity model

- Liquidate the venture
- Approve a change in control of the venture
- Approve a change in the name of the venture
- Approve the venture’s accounting firm

As Company B directs the venture’s most significant activities through a variable interest that does not qualify as equity at risk, the shareholder rights exercisable by Company A and Company B must be assessed to determine whether Company B, as property manager, or the group of at risk equity investors have the power to direct the venture’s most significant activities.

Does the venture’s group of at risk equity investors lack the power to direct the activities that most significant impact its economic performance?

**Analysis**

Yes. Although Company A and Company B have the ability to exercise the rights described above as equity investors of the venture, such rights are not sufficient to demonstrate that the group of at risk equity investors have power. At minimum, the equity at risk must have the ability to remove the property manager, remove the Board (since the Board appears substantive), and approve changes in Company B’s property management agreement, including compensation, to demonstrate that the group has power.

In this fact pattern, Company A and B can each replace their designated Board representatives, and Company A has the ability to withhold its consent to change Company B’s compensation. However, the group’s ability to terminate the property management agreement requires the consent of Company B, the property manager. Because Company B, as an equity investor, has the ability to prevent the group of at risk equity investors from terminating Company B’s property management agreement, this kick-out right is not substantive. Accordingly, rights exercisable by Company A and Company B (as at risk equity investors) are not sufficient to demonstrate that the holders of equity at risk, as a group, have the power to direct the venture’s most significant activities.

If Company A does not have the unilateral, substantive right to kick out Company B as property manager, liquidate the venture, or exercise participating rights, then Characteristic 2 would be present and the venture would be a VIE under ASC 810-10-15-14(b)(1)(ii).

The existence of shareholder rights alone is not sufficient to demonstrate that the holders of equity at risk, as a group, have the power to direct the activities of the potential VIE that most significantly impact its economic performance. A reporting entity should also consider whether such rights are substantive.

Determining whether shareholder rights are substantive requires careful consideration of an entity’s governing documents and may also require an understanding of state law in which the potential VIE is domiciled. Consultation with internal or external legal counsel may be prudent in those situations.

The guidance does not specifically state that these rights must be substantive in order to demonstrate that the at risk equity investors have power. However, we believe non-substantive shareholder rights...
should not drive the reporting entity’s assessment of whether Characteristic 2 is present. We believe the rights exercisable by the holders of equity at risk, as a group, must be substantive to demonstrate that they have the power to direct the activities of the potential VIE that most significantly impact its economic performance.

To be substantive, we believe the group of at risk equity investors must have the ability to exercise such rights implicitly or explicitly. For example, the following may indicate that the rights held by the at risk equity investors are non-substantive:

- The potential VIE is not required to hold an annual meeting
- There is no mechanism for the shareholder group to obtain the identities of the other shareholders and/or convene a general meeting to exercise such rights
- Exercising such rights requires a supermajority vote of the investors as opposed to simple majority vote or lower threshold
- The decision maker holds an equity investment in the entity and can prevent the unrelated at risk equity investors from terminating its decision making arrangement

Figure 2-3 includes a decision tree for this characteristic applicable to entities that are not limited partnerships or similar entities:

**Figure 2-3**
Decision tree for Characteristic 2 applicable to entities that are not limited partnerships or similar entities
**Equity investments with “super” voting rights**

Super-voting common stock may give a shareholder with less than a majority of the economic interests in an entity control over that entity. This would not cause that entity to be a VIE under Characteristic 2 provided that the super-voting common stock is considered equity at risk.

If, however, a shareholder with less than a majority of the economic interests in an entity obtained control of that entity through a management contract, and those rights are not included in the terms of the super-voting common shares, then that entity might be considered a VIE absent (1) rights exercisable by the holders of equity at risk, directly or indirectly, that demonstrate that the group does not lack power, or (2) substantive single party kick-out or participating rights.

**Shareholder agreements**

An entity’s equity investors may enter into a separate contractual arrangement that transfers voting rights. If decision making is determined by a shareholder agreement, and all parties to the shareholder agreement are holders of equity investment at risk, we believe the entity would not be considered a VIE due to the voting arrangement. Such arrangements represent a transfer of voting rights among the group of at risk equity investors, and therefore decision making continues to reside within the group of at risk equity investors.

If an equity investor is granted power over the entity through a shareholder agreement, and that equity investor’s interest does not qualify as equity at risk, then decision making would be outside the equity investment at risk and Characteristic 2 would be present.

**Participating rights held by variable interest holders outside the group of holders of equity at risk**

If substantive participating rights are held by parties other than the holders of the equity at risk, such as a lessee or a lender, it would be difficult to conclude that the group of at risk equity investors has power over the entity’s most significant activities.

For example, if a lender has the ability to veto operating and capital decisions (including decisions that establish an entity’s budgets) and the entity does not have the right or ability to refinance its debt, substantive decision making ability may not rest with the group of holders of equity at risk. As a result, Characteristic 2 would be present and the entity would likely be considered a VIE.

Example 2-24 illustrates evaluation of the impact of participating rights held outside the group of holders of equity at risk.

**EXAMPLE 2-24**

Evaluating the impact of participating rights held outside the group of holders of equity at risk

Entity XYZ owns and operates a theme park. Assume that the decisions that most significantly impact the performance of the entity include maintaining and efficiently operating the existing rides and making capital investments (i.e., incurring capital expenditure for new rides to attract visitors to the theme park). Entity XYZ typically funds its capital investments via a mix of equity and debt financing. However, all capital investment decisions involving new rides require the lender’s approval (one
lender), as the new rides are collateral for the debt financing. The lender’s approval of the expenditure for the new ride is considered part of its standard loan underwriting requirements.

Does the lender’s ability to approve capital investment decisions financed by the lender cause Entity XYZ to be a VIE under Characteristic 2?

**Analysis**

No. The lender’s approval of the expenditure for the new ride is a requirement for securing the debt financing from the lender and is part of the lender’s standard loan underwriting requirements. This type of underwriting requirement is typical in many collateral lending arrangements where the lender approves the project that the funds will be used for. From the lender’s perspective, the approval right is a protective right to ensure repayment of the financing.

On the other hand, if the lender was approving Entity XYZ’s annual operating budgets each year the loan was outstanding, Entity XYZ would likely be considered a VIE under Characteristic 2 since such rights are not typical in loan agreements and the lender can exercise a participating right over an activity of the entity that most significantly impacts its economic performance.

Characteristic 2 may also be present when a party outside the group of at risk equity investors has substantive participating rights. Because the group of at risk equity investors cannot exercise power, the entity would be VIE under ASC 810-10-15-14(b)(1)(ii).

**Nominee shareholder arrangements**

Many reporting entities use nominee shareholders in order to facilitate the consolidation of certain entities. The guidance for nominee shareholders is described in ASC 810-10-20 and 10-25 (see CG 3.6.1). While the guidance was issued to address the consolidation of physician practices by physician practice management entities, the guidance is also relevant to many other entities that utilize nominee shareholders.

Entities that utilize nominee shareholders will likely be VIEs because the entities generally do not have sufficient equity at risk and non-equity holders at risk generally have decision making ability. Examples of structures utilizing nominee shareholders may include: physician practice management arrangements, ownership of entities located in foreign countries that restrict foreign ownership, and local management arrangements in the broadcasting industry. The following example illustrates how a nominee shareholder arrangement may be established.

Assume a foreign investor wishes to acquire an entity located in an Asian country that restricts foreign ownership. In order to effect the acquisition, the foreign investor and the selling shareholder of the Asian entity enter into a contractual arrangement. Under the terms of the contractual arrangement, (1) the foreign investor acquires, for cash, the contractual right to the economic equity interest in the Asian entity from the selling shareholder, (2) the selling shareholder remains the sole legal shareholder of the Asian entity, and (3) the foreign investor retains the right to replace the legal shareholder of the Asian entity at any time by acquiring the shares of the Asian entity from the legal shareholder for a nominal amount, thus effectively retaining all the rights and privileges (voting, dividends, etc.) of the shares of the Asian entity as if it were the legal shareholder of the Asian entity.
Since the requirements for a nominee shareholder are met, as described in ASC 810-10-20 and 10-25, the legal shareholder of the Asian entity would be considered a nominee shareholder of the foreign investor. Generally, the foreign investor, the selling shareholder, and the Asian entity would enter into additional contracts at the same time of the nominee shareholder arrangement, which usually results in the foreign investor consolidating the Asian entity. These additional contracts may include a shareholder voting rights proxy agreement, an equity pledge agreement, and an exclusive business cooperation agreement, among others.

**Special considerations**

Franchise agreements, physician practice management business models, and other entities controlled by contract require special consideration. Although physician practice management entities are often VIEs, the applicable guidance is discussed in the literature in the context of the VOE model. See CG 3.6.1 for information on physician practice management entities.

**Franchise business models**

The use of franchises is prevalent in the retail and consumer industry. In a typical franchise arrangement, a company will license the right to use its name, trademarks, and general operating philosophies and practices to individuals or entities in varying geographic regions. The franchisor will allow the operator (franchisee) to use its trademark and distribute goods or provide services in exchange for a royalty or franchise fee. The franchisor typically retains responsibility for regional or national advertising, and negotiates terms with approved vendors from whom the franchisees are required to purchase their raw materials. In doing so, the franchisor creates synergies in the form of cost reductions and broad-based marketing that is intended to benefit the franchisee group as a whole.

Franchise agreements differ greatly from company to company, and a careful analysis of these arrangements is necessary to determine whether the franchisor has rights that cause the franchisee to be a VIE under Characteristic 2.

Franchise agreements typically require a franchisee to strictly adhere to specific, standardized operating protocols. In many cases, the franchisor’s policies and procedures stipulate the following:

- Policies and procedures for running the business, including personnel policies
- That the owner of the franchise location, as well as the franchisee’s employees, must be trained by the franchisor
- Usage of the franchisee’s logo or trademark
- Usage of the franchise location’s store and appearance
- Uniforms to be worn by employees
- Hours of operation
- Procurement and supply of raw materials
- The territory in which the franchisee is authorized to operate within
Although the stipulations imposed by a franchisor may, on the surface, appear to limit the franchisee’s ability to operate autonomously, they do not necessarily cause the franchisee to be a VIE under Characteristic 2. In most cases, franchisees are required to conform to stipulations imposed by the franchisor to ensure the quality of the franchisor’s products or services is uniform and consistent across all locations. That is, the requirements imposed by the franchisor are generally intended to protect the value of the franchisor’s brand (i.e., the franchisor’s rights are protective in nature) as opposed to allow the franchisor to exercise power. The ability of any party to exercise protective rights does not cause an entity to be a VIE under Characteristic 2.

Conversely, if the stipulations imposed by the franchisor are designed to enable the franchisor to control the franchisee’s operations, then Characteristic 2 may be present and the franchisee may be a VIE. The determination of whether a franchisor’s rights are protective in nature can be judgmental and requires careful consideration of the relevant facts and circumstances.

Since many of the franchisee’s activities are predetermined by the franchise agreement, the focus of this analysis should shift to the franchisee’s activities that the holders of equity at risk can direct. This analysis should not consider decisions that are administrative or inconsequential as those decisions pertain to activities of the entity that do not significantly impact the entity’s economic performance.

We believe a franchisee may have the power to direct the franchisee’s most significant economic activities when (1) the stipulations imposed by the franchisor are designed to protect its brand, rather than to convey power over its franchisee’s most significant activities, and (2) the franchisee has the discretion to make all other important decisions impacting the economic performance of the franchisee, such as:

- The daily delivery of quality products or services to customers
- Establishing and executing capital and operating budgets
- Execution of the franchisor’s operating systems
- Establishing the pricing of products or services sold at the franchise location
- Hiring, scheduling, terminating, and setting the compensation of the franchise’s employees

In addition, we believe the fact that the franchisee voluntarily agreed to operate the business in accordance with the franchisor’s established rules and regulations may demonstrate that the holders of equity at risk, as a group, have power. That is, the success or failure of the franchisee primarily rests with the franchisee’s owners as opposed to the franchisor. The list described above is not all inclusive and the facts and circumstances specific to each franchisee should be carefully considered.

Situations where a franchisor extends a loan or owns equity in a franchisee should be closely evaluated to determine whether the franchisee or the franchisor has the power to direct the franchisee’s most significant activities. As the level of economics held by the franchise owners decreases, the ability of the owner of the franchisee to exercise power over the entity’s economically significant activities should be evaluated with skepticism. Conversely, as the franchisor’s level of economic ownership in a franchisee increases, the likelihood that its decision making rights have migrated from protecting its brand to impacting the economic performance of that franchise location will increase.
2.3.3.3  VIE characteristic 3: equity with nonsubstantive voting rights

**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).

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 Characteristic 3 if both of 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 (e.g., to avoid consolidation) where the voting rights held by the entity’s investors are not useful in identifying which party has a controlling financial interest in the entity being evaluated for consolidation.

**Criterion 1: disproportionate voting and economics**

Under Criterion 1, each equity investor should be evaluated individually 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 five characteristics of a VIE in that all variable interests held by the holders of equity at risk must be considered, and not just the voting rights and economics related to each investor’s equity investment.

Related parties should not be considered in the evaluation of Criterion 1, but should be considered in an evaluation of Criterion 2 (discussed below).
When evaluating whether Criterion 1 has been met, we believe an investor’s voting rights and economics are not required to be identical, but should generally be approximately the same, to be considered proportionate. Judgment should be applied based on the facts and circumstances.

Question 2-6 addresses whether Criterion 1 is met when a reporting entity’s economic interest in an entity is greater than its relative voting interest.

**Question 2-6**

If a reporting entity’s economic interest in an entity is greater than its relative voting interest, is Criterion 1 met?

**PwC response**

The disproportionate voting and economic interest criterion was included to identify entities designed with nonsubstantive voting rights. It is the intent of GAAP to subject those entities to the “power” and “economics” model established in ASC 810-10. In situations where the interests are disproportionate, it should not be automatically assumed that the criterion is met. Additional analysis should be performed to determine whether the entity’s voting rights would be substantively different if its relative voting rights mirrored its economic interest.

For example, if an investor held a 25% economic interest in an entity but was limited to exercising 15% of its relative voting rights, a reporting entity should consider whether that investor’s ability to influence or participate in the entity’s operating or financial decisions would be substantively different if the investor held 25% of the entity’s relative voting rights. If the investor’s ability to influence or participate in the entity’s operating or financial decisions would not be substantively different if it held 25% of the entity’s relative voting interests, then it should not be assumed that the investor’s voting and economic interests are disproportionate (i.e., that Criterion 1 is met).

When an investor’s economic and voting interests straddle 50% (i.e., 48% voting rights and 52% economics), its voting and economic interests should not ordinarily be considered proportional. Generally, an investor’s ability to exercise voting rights over an entity would be substantively different when its voting interest crosses the 50% threshold.

In practice, joint ventures and partnerships frequently meet this criterion as the equity investors typically have other variable interests in the entity that create economics that are disproportionate to their voting rights.

Based on a literal read of the guidance, evaluation of Criterion 1 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 investor. However, in some circumstances, detailed analyses may not be necessary. For example, if one party clearly has an economic participation of 60% or greater, but only has a noncontrolling 50% voting interest, 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% of the vote and 40% 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
investor’s incremental economic exposure through the purchase contract causes the equity investor to be exposed to greater than 50% of the entity’s expected losses and residual returns.

The determination of the level of voting rights may require judgment, since, in many cases, voting percentages are not defined by the underlying agreements.

Question 2-7 addresses the level of voting rights investors are deemed to hold when the investors agree to all significant operating decisions, but their relative ownership interests are not equal.

**Question 2-7**

If a partnership with three investors operates in a manner that requires all three investors to agree to all significant operating decisions, what level of voting rights should the partners be considered to hold if their relative ownership interests are not equal?

**PwC response**

Even though the partners’ legal ownership percentages may vary, we believe the entity is under joint control and each partner would have 33.3% of the partnership’s voting interests.

In this scenario, when assessing whether Criterion 1 of Characteristic 3 has been met, the analysis should focus on whether the governance of the entity would be substantively different if voting rights were exactly equal to the investor’s economic interest. If the governance of the entity would be substantively different, then Criterion 1 of Characteristic 3 would be met.

To further understand the application of Criterion 1, consider Example 2-25, Example 2-26, and Example 2-27.

**EXAMPLE 2-25**

**Determining whether a majority investor's interest is disproportionate**

Company A holds a 65% equity interest in Entity 1 and Company B holds the remaining 35% equity interest. Company A and Company B share in Entity 1’s profits and losses in proportion to their relative equity investment. Entity 1’s governing documents include specific provisions providing Company B with approval rights over the substantive operating decisions of Entity 1 (i.e., joint control).

Is Criterion 1 met?

**Analysis**

Yes. Entity 1’s governing documents provide Company A with a 50% vote over key operating decisions. If Company A’s voting rights equaled its 65% economic interest, its right to govern Entity 1 would be substantively different. Consequently, Criterion 1 would be met. If Criterion 2 is also met (i.e., substantially all of the entity’s activities either involve or are conducted on behalf of Company A and its related parties), Characteristic 3 would be present and Entity 1 would be considered a VIE.
EXAMPLE 2-26
Determining whether a majority investor’s interest is disproportionate

Company A is an equity investor in Corporation X, holding 55% of Corporation X’s voting interests. Through its 55% voting interest, Company A is able to control Corporation X. Company A is exposed to 60% of Corporation X’s profits and losses.

Is Criterion 1 met?

Analysis

No. Although Company A’s voting rights (55%) and exposure to Corporation X’s economics (60%) are not exactly equal, Company A’s voting and economic interests would be considered proportional since control resides with Company A at either the 55% or 60% level.

EXAMPLE 2-27
Determining whether other interests held by a 50% equity investor cause disproportionality

Company A and Company B each contributed $20 million in cash for 50% of Corporation X’s common stock. In addition, Company A loaned $50 million to Corporation X in return for a note receivable. Company A therefore has two variable interests in Corporation X: (1) an equity investment and (2) a note receivable from Corporation X.

Is Criterion 1 met?

Analysis

Most likely. While it is likely that the note receivable absorbs little variability in the change in Corporation X’s net assets given its seniority in Corporation X’s capital structure (i.e., it exposes Company A to little credit risk), it would be required to absorb very little variability to increase Company A’s total economic exposure above 50%.

Criterion 2: evaluating the “substantially all” concept

For Characteristic 3 to be present, 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 (and its related parties) with disproportionately few voting rights. We believe an evaluation of whether this criterion has been fulfilled should be consistent with the evaluation performed under the business scope exception given the consistency of the “substantially all” terminology used (refer to CG 2.1.2.4 for discussion of the business scope exception).

As a general rule, we believe this assessment should be primarily qualitative.

Figure 2-4 lists indicators to consider in our evaluation (this is the same list of indicators included in CG 2.1.2.4):
### Figure 2-4
Indicators of whether the substantially all criterion have been met

<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 <strong>substantially all</strong> of its products to the reporting entity under long-term contracts.</td>
<td>□ The entity’s major activities include selling a <strong>majority</strong> of its products to the reporting entity, and these arrangements are expected to continue either because of long-term contracts or for other reasons.</td>
</tr>
<tr>
<td>□ The entity’s major activities include purchasing <strong>substantially all</strong> of its purchased products from the reporting entity.</td>
<td>□ The entity’s major activities include purchasing a <strong>majority</strong> 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 all</strong> 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>□ 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>
</tbody>
</table>
Variable interest entity model

### Strong indicators

- 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.

- The economics (e.g., capital at risk, participation in profits, etc.) are heavily skewed (e.g., close to 90% or greater) toward the reporting entity.

### Other indicators

- 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.

- The economics (e.g., capital at risk, participation in profits, etc.) are weighted (e.g., greater than 60%) toward the reporting entity.

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

In contrast to Criterion 1, the investor must combine interests held by its related parties with its own interests when assessing Criterion 2 (refer to CG 2.4.2.5 for a detailed description of related parties and de facto agents).

If several of the “Other indicators” are present, the reporting entity should consider whether or not the requirements of Criterion 2 have been met. 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 (i.e., 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” and this assessment requires judgment and will be based on facts and circumstances. Some have suggested that the phrase “substantially all” should be interpreted to mean that 90% or more of the economics of the entity relate or accrue to the benefit of a particular party. 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.

### 2.3.3.4 VIE characteristic 4: lack of obligation to absorb losses

Non-equity interests (e.g., debt) issued by voting entities generally do not absorb the entity’s losses until its equity interests are fully depleted. 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:
### 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.

This assessment should focus on whether the entity’s equity investors are exposed to its expected losses on a “first-dollar loss” basis.

### 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.

### Application of Characteristic 4

An evaluation of whether Characteristic 4 is present should focus on the equity interests as opposed to the identity of the equity investors. In most cases, a reporting entity should be able to make this assessment qualitatively.

When other variable interests that do not qualify as equity at risk absorb the entity’s expected losses before its equity at risk is fully depleted, we do not believe the entity should automatically be presumed to be a VIE.

We believe Characteristic 4 may be present if a potential VIE is designed such that its equity interests do not fully absorb the entity’s expected losses on a first-dollar loss basis. If other variable interests begin sharing in the entity’s expected losses before the equity investment at risk is fully depleted, and that sharing is part of the entity's design, then the entity may be a VIE. An entity may also be a VIE under Characteristic 4 if it issued equity with puttable characteristics that are embedded in the terms of the interest.

### Impact of implicit variable interests

ASC 810-10-25-48 through ASC 810-10-25-54 address if and when a reporting entity holds an implicit variable interest in a potential VIE. The existence of an implied variable interest may affect the determination of whether an entity should be considered a VIE, particularly with respect to Characteristic 4. For example, if a variable interest holder implicitly guaranteed the value of a potential VIE’s sole asset, then the entity would be considered a VIE under Characteristic 4. In that situation, the implied guarantee protects the holders of equity at risk from suffering the entity's expected losses before the equity at risk is fully depleted.

See CG 2.2.6 for a further discussion of implicit variable interests.
Examples of how to evaluate an entity under Characteristic 4

The following examples illustrate how to assess whether the entity being evaluated for consolidation is considered a VIE under Characteristic 4.

Disproportionate loss sharing arrangements

Disproportionate sharing of expected losses among the holders of equity at-risk do not cause an entity to be a VIE under Characteristic 4. The assessment of whether Characteristic 4 is present should be based on an analysis of the holders of equity at risk, as a group, as opposed to individual at-risk equity investors.

Disproportionate sharing arrangements among individual equity investors do not shield the holders of equity investment at risk, as a group, from absorbing the entity’s expected losses. Such arrangements change the manner in which the individual holders of equity at risk absorb the entity’s expected losses. Although holders of equity at risk may individually be protected from the entity’s expected losses to some extent, the group would continue to be exposed the entity’s expected losses on a first-dollar basis.

Debt guarantees

A debt guarantee generally would be considered a variable interest under the VIE model because it may absorb some portion of the entity’s expected losses. As a result, a reporting entity must determine whether the guarantee was incorporated into the design of the entity to protect the entity’s equity investors from absorbing the potential VIE’s expected losses on a first-dollar loss basis.

Debt guarantees are generally not called upon until the equity investment at risk is fully depleted. Therefore, debt guarantees typically do not cause the entity to be a VIE under Characteristic 4. Reporting entities should, however, carefully consider whether the existence of a debt guarantee causes an entity to be a VIE under Characteristic 1. Refer to CG 2.3.3.1 for further discussion.

Residual value guarantees provided by a lessee

In many leasing transactions, a lessor may require the lessee to provide a residual value guarantee on the asset that is subject to the lease arrangement. The residual value guarantee is intended to protect the equity investors of the lessor from any decline in the fair value of the leased asset. In other words, the residual value guarantee will absorb losses before the equity at risk is fully depleted.

To determine whether a lessee provided residual value guarantee causes an entity to be a VIE under Characteristic 4, a reporting entity should first consider whether the residual value guarantee represents a variable interest in the lessor entity. If the residual value guarantee is a variable interest in the lessor entity, and that variable interest absorbs the lessor entity’s expected losses before its equity at risk is fully depleted, Characteristic 4 would be present and the lessor entity would be a VIE.

When a lessee provides a residual value guarantees on specified assets that represent less than 50% of the fair value of the potential VIE’s total assets, the residual value guarantee would not be considered a variable interest in the entity (the residual value guarantee would represent a variable interest in specified assets). If the residual value guarantee does not represent a variable interest in the entity, Characteristic 4 would not be present and the lessor entity would not be a VIE.
Conversely, a lessee provided residual value guarantee would be considered a variable interest when the guarantee is provided on the lessor's entity's sole asset, or specified assets that represent greater than 50% of the fair value of the lessor entity's total assets. If the residual value guarantee is a variable interest, then the lessor entity would be a VIE under Characteristic 4.

Refer to CG 2.2.7 for further discussion around the distinction between variable interests in specified assets versus variable interests in an entity.

*Residual value guarantees on an entity's assets provided by an equity investor*

An equity investor may provide a residual value guarantee on an asset that the investee (a legal entity) holds. If the fair value of the asset subject to the residual value guarantee represents greater than 50% of the fair value of the entity's total assets, the residual value guarantee would be a variable interest in the entity and the arrangement may cause the entity to be a VIE under Characteristic 4. Although the investor may have the economic obligation to absorb the entity's losses on a first-dollar basis, the obligation stemming from the residual value guarantee is not embedded in the terms of the investor's equity interest and would begin absorbing the entity's expected losses before the equity at risk is fully depleted.

*Insurance contracts*

Entities routinely enter into insurance arrangements to insulate themselves from risk of loss arising from unforeseen events (e.g., fires, storms) or unplanned interruptions of their business operations. Examples of such arrangements include property and casualty and business interruption insurance. Applying Characteristic 4 to these contracts on a literal basis would cause many traditional companies to be considered VIEs.

Although normal and customary insurance arrangements protect an entity’s equity investors from risk of loss, we do not believe Characteristic 4 is intended to capture such situations. If these normal and customary insurance arrangements protect the equity investors from risk of loss stemming from the occurrence of unusual events, as opposed to losses that occur in the normal course of business (i.e., the predominant risks the entity was designed to create and pass along to its variable interest holders), we do not believe such arrangements would cause an entity to be a VIE under Characteristic 4. The group of at risk equity investors must, however, be exposed to risk of loss arising in the normal course of business to demonstrate that an entity is not a VIE under Characteristic 4.

*Total-return swaps*

Total-return swaps are an example of a variable interest that generally causes an entity to be a VIE under Characteristic 4. If a total-return swap protects the group of at risk equity investors from an entity’s expected losses, then Characteristic 4 would be present and the entity would be considered a VIE.

Example 2-28 illustrates the assessment of the impact of a total-return swap under Characteristic 4.
EXAMPLE 2-28
Assessing the impact of a total-return swap under Characteristic 4

Company A (1) issues debt of $250 and common stock of $50, and (2) acquires a bond with a fair value of $300. Assume that Company A enters into a total-return swap with Bank B. The terms of the arrangement provide that Bank B will pay 85% of the total return of the bond in exchange for a LIBOR-based return. That is, if the bond’s value declines by one dollar, the Bank B will pay the entity 85%.

Does the total-return swap cause Company A to be a VIE under Characteristic 4?

Analysis

Yes. The equity interests are protected from 85% of the asset’s losses. As a result, the entity would be deemed a VIE under this characteristic.

Cost-plus sales contracts

Sometimes manufacturers or service providers, acting in the capacity of a vendor, sell goods or services at a price that allows the vendor to recoup some or all of its operating costs plus a fixed margin. These arrangements are commonly referred to as “cost-plus” sales contracts.

Cost-plus sales contracts may cause the entity selling the goods or services (the vendor) to be a VIE under Characteristic 4 if the arrangement protects the vendor’s equity investors from absorbing the entity’s expected losses. The most straightforward example of where a cost-plus sales contract protects a vendor’s equity investors from suffering its expected losses is when the vendor sells all of its goods or services to a single customer at a price that varies based on its operating costs plus a fixed or variable mark-up. In that situation, the vendor’s customer would bear all of the entity’s operating risk through its variable pricing structure, thereby insulating the vendor’s equity investors from risk of loss.

Example 2-29 illustrates the assessment of the impact of a cost-plus sales contract under Characteristic 4.

EXAMPLE 2-29
Assessing the impact of a cost-plus sales contract under Characteristic 4

Company A and Company B formed Corporation X, each contributing $1,000 of cash in exchange for a 50% equity interest at formation. Corporation X also executed a sales agreement with Company A at formation, the terms of which require Company A to purchase 90% of the goods Corporation X manufactures. The price paid by Company A is equal to the costs to produce the goods, plus a 7% markup.

Does the supply agreement cause Corporation X to be a VIE under Characteristic 4?

Analysis

Yes. The sales contract, which is not part of Corporation X’s equity at risk, protects its equity investors from substantially all of its operating risks. Although Company A and Company B are exposed to 10%
of Corporation X’s operating risks, this is not significant enough to overcome the level of protection provided based on the design of the entity. As such, Characteristic 4 would be present and Corporation X would be a VIE.

Some element of all commercial pricing arrangements is based on the vendor’s operating costs plus a profit margin. Assessing whether such arrangements indicate the presence of Characteristic 4 should be based on the relevant facts and circumstances. This analysis becomes more complicated when the vendor sells goods or services to different customers or when it renegotiates pricing with customers on a recurring basis.

We believe cost-plus sales arrangements with pricing schemes that reset periodically may indicate that the vendor’s equity investors are insulated from all operating risk, thereby causing the entity to be a VIE under Characteristic 4. Determining whether Characteristic 4 is present would ultimately require consideration of the level of protection the vendor’s at risk equity investors are provided through the arrangement.

When a vendor entity’s pricing of its goods or services is determined on an ex-ante basis (e.g., pricing is set at the beginning of a quarter), and its equity investors are substantively exposed to the vendor’s operating risk (i.e., it is reasonably possibly they could suffer losses of the vendor), we do not believe Characteristic 4 would be present.

**Purchased fixed-price put options on an entity’s assets**

An entity may purchase protection against a decline in the fair value of one or more assets it holds. If this downside protection is obtained through a fixed-price put option on the entity’s assets, a reporting entity should determine whether the put option represents a variable interest in the entity or a variable interest in specified assets. If the put option represents a variable interest in specified assets, then the purchased put option does not protect the group of at risk equity investors from the entity’s expected losses. Consequently, the entity would not be a VIE under Characteristic 4.

Conversely, a fixed-price put option that is a variable interest in the entity as a whole may demonstrate that Characteristic 4 is present and the entity would be a VIE. A purchased fixed-price put option on an entity’s assets represents a variable interest in the entity as a whole when the puttable assets underlying the option represent greater than 50% of the entity’s assets on a fair value basis. If the put option is a variable interest in the entity and begins to share in the entity’s expected losses before the equity investment at risk is fully depleted, Characteristic 4 would be present and the entity would be a VIE.

**Purchased fixed-price put options on an entity’s equity interests**

A purchased fixed-price put option on an entity’s equity interest may cause either the equity interest to not qualify as equity at risk or the entity to be a VIE under Characteristic 4. If the put feature is embedded in the terms of the equity interest (e.g., the entity issues puttable shares to the equity investor), the equity interest will likely not be equity at risk since the equity interest will not participate in losses of the entity. If the put feature is not embedded in the terms of the equity interest (e.g., the equity investor buys a put option from one of the other equity investors of the entity) the equity interest would be equity at risk, assuming all the other equity at risk conditions are met. However, if the terms of the put are substantive (e.g., in-the-money put with a reasonable term), the put feature
would cause the equity interest to be protected from losses and therefore the entity would be a VIE under Characteristic 4.

In contrast, an equity investor may purchase a put option from a third party to insulate itself from a degradation in the fair value of the potential VIE’s equity value. If that downside protection is obtained through a freestanding contract that was entered into as part of the equity investor’s normal trading activities, it is unlikely that Characteristic 4 would be present. Although the current holder of that equity interest may be protected against all or some portion of the entity’s expected losses, the put would not be considered a VI because it was not acquired as part of the purpose and design of the entity. As such, we do not believe such arrangements would cause an entity to be a VIE under Characteristic 4.

Other instruments that provide protection to the equity investment at risk

Other examples of variable interests in an entity that would cause an entity to be a VIE under Characteristic 4 are:

- Guarantees of the entity’s assets when that guarantee is a variable interest in the entity and not in specified assets (refer to CG 2.2.7 for discussion of variable interests in specified assets)

- A purchase agreement or option with a non-refundable deposit that protects the equity investment at risk from a portion of the market decline (to the extent of the deposit).

Question 2-8 provides an illustration of the VIE analysis for an entity that enters into a purchase and sale agreement with an entity whose sole assets are subject to the agreement.

**Question 2-8**

Company A enters into a purchase and sale agreement with Company X, whereby Company A will buy from Company X land and a building, its sole assets. Company A is required to pay a non-refundable deposit to Company X and has the right to terminate the contract, subject to the loss of its deposit. Should Company X be considered a VIE?

**PwC response**

Yes. The purchase and sale agreement requires Company A (buyer) to make a significant 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 Company X’s variability and transfers some of the risks and rewards of ownership to Company A. The protection provided to the seller through the non-refundable deposit causes Company X to be a VIE under Characteristic 4. In essence, the non-refundable deposit provides protection to Company X’s at-risk equity investors from declines in value of the underlying asset on a first-dollar loss basis before the equity investment at risk is fully depleted. Once the non-refundable deposit is depleted, the at-risk equity investors would begin participating in further declines in the fair value of the entity’s asset.

**2.3.3.5 VIE characteristic 5: lack of right to receive residual returns**

Characteristic 5 is based on the principle that traditional voting entities issue equity interests that allow the holder to receive the entity’s residual profits. The VIE model indicates that an entity is also considered a VIE if, as a group, the holders of the equity investment at risk lack the following:
The right to receive the expected residual returns of the legal entity. The investors do not have that right if their return is capped by the legal entity’s governing documents or arrangements with other variable interest holders or the legal entity. For this purpose, the return to equity investors is not considered to be capped by the existence of outstanding stock options, convertible debt, or similar interests because if the options in those instruments are exercised, the holders will become additional equity investors.

The intent of Characteristic 5 is also 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.

How to evaluate Characteristic 5 in practice

An evaluation of whether Characteristic 5 is present should focus on the equity interests as opposed to the identity of the equity investors. In most cases, a reporting entity should be able to make this assessment qualitatively.

When other variable interests that do not qualify as equity at risk share in, or fully absorb an entity’s expected residual returns, the entity that issued those equity interests may be a VIE. We believe Characteristic 5 may be present if a potential VIE is designed to issue equity interests that do not provide the holder with the ability to receive an entity’s expected residual returns. If an entity was designed to issue equity interests that do not allow the holder to participate in the entity’s expected residual returns (i.e., the equity interests have embedded fixed-price callable features), we believe the entity may be a VIE.

In other instances, a variable interest that does not qualify as equity at risk may share in the entity’s expected residual returns. For example, an entity may enter into arrangements with a service provider that include a performance-based compensatory element. If that other variable interest was not entered into as part of the entity’s purpose and design, but was entered into as part of the entity’s normal course of business (i.e., normal course sharing arrangements), the entity would not be a VIE. In making this evaluation, we believe that variable interests that share in a large portion (e.g., 30%) of an entity’s expected residual returns would not likely be a normal course of business feature.

In most cases, a qualitative assessment should be sufficient to determine whether the at risk equity investors have the rights to the entity’s expected residual returns.

Examples of how to evaluate an entity under Characteristic 5

There are many contracts that may or may not cause an entity to be a VIE under Characteristic 5. The following are some examples:
Disproportionate sharing of returns among equity investors

Disproportionate sharing of expected residual returns among the holders of equity at risk does not cause an entity to be considered a VIE under Characteristic 5. Characteristic 5 focuses on whether the group of at risk equity investors has the rights to the entity’s expected residual returns, as opposed to the manner in which the expected returns are shared among the group.

Disproportionate sharing arrangements change the manner in which the individual holders of equity at risk receive the entity’s expected returns. Although individual holders of equity at risk may individually be prohibited from receiving the entity’s expected residual returns to some extent, the group would continue to fully receive the entity’s expected returns.

Written fixed-price call option on the entity’s assets

Written call options on an entity’s assets that represent less than a majority of the entity’s total assets on a fair value basis would not be considered a variable interest in the entity as a whole (from the holder’s perspective). If the written call option does not represent a variable interest in the entity, it would not cap the ability of the holders of equity at risk, as a group, from receiving the potential VIE’s expected residual returns.

If the assets underlying the written call option represent more than 50% of the entity’s total assets on a fair value basis, then the written call option may cap the investor’s ability to receive the entity’s expected residual returns. Determining whether the written call option functions as a cap depends on the specific facts and circumstances. Relevant factors will include whether the option’s strike price is fixed, formula-based, or at fair value. A call option with a fair value strike price would not meet Characteristic 5, whereas a call option that is formula-based may meet Characteristic 5.

Written fixed-price call options on the entity’s equity interests

Written fixed-price call options on an entity’s equity interest would allow the holder of the call to participate in the entity’s expected residual returns. If the amount of the expected residual returns absorbed by the call was large in relation to the expected residual returns absorbed by the entity’s total equity, the entity would be a VIE.

Example 2-30 illustrates the assessment of the impact of a written call on an equity interest.

EXAMPLE 2-30

Assessing the impact of a written call on an equity interest

Company A and Company B formed Corporation X. At formation, Company A received a 75% equity interest in exchange for a $750 cash contribution. Company B received a 25% equity interest in exchange for a $250 cash contribution. All of Corporation X’s profits and losses are shared among Company A and Company B in accordance with the relative ownership percentages.

Subsequent to the formation of Corporation X, Company A wrote a call option to Company C allowing Company C to purchase Company A’s 75% equity interest for $1,000 at any time for a period of two years. The call option was entered into as a part of the redesign of Corporation X and is a free standing financial instrument.
Does Company C’s call option on Company A’s 75% equity investment cause Corporation X to be a VIE under Characteristic 5?

Analysis

Maybe. While the call provides Company C with rights to a portion of Company X’s expected residual returns, the extent of those rights would need to be assessed. The call is written out of the money and has a limited term of two years. These features together with the relevant facts around Company X’s operations may support a conclusion that the amount of expected residual returns absorbed by the call may not be substantial (in which case the entity would not be a VIE).

In some cases, the potential VIE may write a call option on its own equity interests. The call option may be freestanding and issued as compensation, or embedded in another financial instrument that was issued as part of a financing transaction. Examples include employee stock options, convertible debt, or similar interests. These variable interests should not cause the issuer of such interests to be a VIE under Characteristic 5 since the purchaser or holder of these options will become part of the group of at-risk equity investors upon exercise.

Outsourced decision-making fee arrangements

An entity may enter into an arrangement with a service provider that includes a performance-based compensatory element. If a reporting entity concludes that a decision-making fee arrangement is not a variable interest in the entity as discussed in CG 2.2.4, we do not believe the fee arrangement would cause the entity to be a VIE. Such arrangements are consistent with other normal course sharing arrangements and do not demonstrate the existence of Characteristic 5.

If a reporting entity concludes that a service provider arrangement represents a variable interest in the entity, further analysis would be required to determine whether the reporting entity can participate in a large portion of the entity’s profits. If so, we believe such arrangements may be inconsistent with normal course sharing arrangements and the entity should be considered a VIE.

The following arrangements should be carefully considered to determine whether they cause an entity to be a VIE under Characteristic 5:

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

We believe 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 a large portion of the entity’s expected residual returns would cause an entity to be a VIE under Characteristic 5.

In most entities, these arrangements would not demonstrate the presence of this characteristic; however, a reporting entity should evaluate the terms of each contract and the level of the entity’s returns that the counterparty is entitled to share in.
Other 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 (sometimes referred to as “sweat equity”). Because “sweat equity” does not qualify as equity at risk, a reporting entity must consider whether this equity investment caps the at-risk equity investors’ ability to receive the entity’s expected residual returns. We believe this would be the case when equity investments that do not qualify as equity at risk share in a large portion of the entity’s expected residual returns.

Example 2–31 illustrates the assessment of the impact of an equity investment that is not at risk under Characteristic 5.

**EXAMPLE 2–31**

Assessing the impact of an equity investment that is not at risk under Characteristic 5

Company A and Company B formed Corporation X. At formation, Company A received a 65% equity interest in exchange for a $1,000 cash contribution. Company B received a 35% equity interest in return for future services. All of Corporation X’s cash flows are distributed to Company A and Company B in accordance with the relative ownership percentages.

Because Company B received its interest in exchange for future services, its equity investment does not qualify as equity at risk.

Does the existence of Company B’s 35% equity investment cause Corporation X to be a VIE under Characteristic 5?

**Analysis**

Since Company B participates in the entity’s expected residual returns, Characteristic 5 may be present if Company B is entitled to a large portion of returns in relation to the entity’s total expected returns. If so, Characteristic 5 would be present and the entity would be considered a VIE. Generally, a 35% sharing rate would be considered large.

2.3.4 **When to reconsider VIE status**

If a reporting entity has a variable interest in a legal entity that does not qualify for a VIE scope exception, then it is required to determine whether that entity is a VIE at its formation date, or on the date the reporting entity first became involved with the entity.

Certain events may occur after the initial analysis that require the reporting entity to reassess whether or not an entity is, in fact, a VIE. In the VIE model, the occurrence of any of the following specific events would require the reconsideration of an entity’s VIE status:

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

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

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

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

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

A troubled debt restructuring should also trigger a reassessment of the entity’s status as a VIE. 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, although they may become subject to the VIE disclosure requirements (see FSP 18 for a discussion about disclosure requirements).

We believe only substantive events should trigger reconsideration of the entity’s VIE status. The determination of whether an event is substantive requires judgment.

2.3.4.1 Reassessment of the design of an entity upon a reconsideration event

A reporting entity should consider the purpose and design of a potential VIE, including the risks it was designed to create and pass along to its interest holders, when determining whether the entity is a VIE. The entity’s purpose and design must also be considered upon the occurrence of any event triggering a reassessment of the entity’s status as a VIE. This could require the reporting entity to consider new or different risks (e.g., interest rate risk) that the entity has become exposed to since the prior analysis was performed.

The following sections discuss each of the reconsideration events described in the VIE model in further detail.

2.3.4.2 VIE reconsideration event — 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 an entity’s expected losses that reduce its equity at risk should not trigger a reconsideration of an entity’s VIE status. The rationale behind this concept focuses on the design of the entity. Incurring operating losses alone does
not impact the characteristics of the equity investment at risk or the relationship between the holders of equity at risk and other variable interest holders.

If the equity at risk was deemed sufficient to finance the entity’s expected activities in the initial VIE analysis, and no events that could be considered a “redesign” of the entity have occurred (such as those events described above), then there would be no basis to conclude that the entity has become a VIE just because it has incurred operating losses.

It should be noted, however, that if a reconsideration event 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 may need to be considered as part of that analysis.

2.3.4.3 VIE reconsideration event — change in governing documents/contracts

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 determine whether a change in these documents/arrangements should trigger a reconsideration of the entity’s VIE status.

Only modifications that affect the characteristics or adequacy of the entity’s equity investment at risk are considered reconsideration events.

2.3.4.4 VIE reconsideration event — changes in characteristics of equity

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 impacting the adequacy of the equity at risk.

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 consider whether the modifications in the governing documents 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. Whether the rights ceded to the other variable interest holders were participating or protective rights

2. Whether the entity’s VIE status would change based solely on the changed characteristics

If the modification changes the characteristics of the entity’s equity investment at risk, it would be deemed a reconsideration event under the VIE model.
2.3.4.5 VIE reconsideration event — change in adequacy of equity 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 can be challenging. This difficulty arises from the need to determine what caused the change in the adequacy of the equity investment at risk. Only significant modifications that directly impact the adequacy of the equity investment at risk would be considered triggering events that would require a reassessment of the entity's VIE status.

2.3.4.6 VIE reconsideration event — return of investment to equity investors

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 an equity investment may constitute a redesign of the entity. Since one of the five characteristics of a VIE focuses on the sufficiency of the equity investment at risk, a reduction in that amount would generally trigger a reassessment of an entity’s VIE status.

The reporting entity should consider whether or not the return of equity at risk is significant before concluding that the reduction in equity at risk constitutes a reconsideration event. This reconsideration event is intended to focus on situations in which a return of capital has caused a voting interest entity to become a VIE.

2.3.4.7 VIE reconsideration event — entity undertakes additional activities

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. Specifically, it focuses on whether or not the unanticipated activities or newly acquired assets actually increase the entity’s expected losses.

When analyzing this reconsideration event, reporting entities should consider whether there has been a redesign of the entity. During the initial VIE analysis, a reporting entity is required to assess the sufficiency of the equity at risk by evaluating the entity’s current and anticipated activities and the amount of equity needed to finance those expected activities (either quantitatively or qualitatively). In a quantitative analysis, that assessment would involve calculating the potential VIE’s expected losses—a calculation that would be derived from the variability or risk associated with the current and anticipated future activities of the entity. Consider Example 2-32.
EXAMPLE 2-32
Determining whether a change in an entity’s activities requires a reconsideration of an entity’s status as a VIE

Company A holds two financial assets: one share of stock in a “Blue Chip” utility company and one share of stock in a tech start-up company that has yet to earn a profit. At inception, Company B (one of Company A’s equity investors) determined that Company A was not a VIE.

Six months later, Company A sells its share of stock in the utility company and buys an additional interest in the start-up company.

Does Company A’s sale of the utility stock and acquisition of an additional interest in the start-up company require Company B to reassess Company A’s status as a VIE?

Analysis

If the acquisition of this new asset was not anticipated at Company A’s inception and Company A’s expected losses have increased as a result of the purchase, Company B would be required to reassess Company A’s VIE status.

If the reporting entity anticipated the undertaking of new activities or the acquisition of additional assets in its initial assessment under the VIE model, the occurrence of such events may not be considered a reconsideration event.

We believe 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). The threshold for concluding that a reconsideration event has occurred will likely be higher for an operating joint venture than an SPE.

In making the assessment, 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.

2.3.4.8 VIE reconsideration event – change in equity or expected losses

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.

The previous two reconsideration events focus on events that may cause a voting interest entity to become a VIE. Alternatively, 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 investments that potentially increase the sufficiency of the equity at risk.
Additionally, if the entity modifies its activities in a way that decreases its expected losses, equity at risk that was once deemed insufficient may become sufficient under Characteristic 1.

2.3.4.9 **VIE reconsideration event — equity group at risk loses power**

**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, the group of at-risk equity investors lose the power through voting or similar rights to direct the activities of the entity that most significantly impact its economic performance.

2.3.4.10 **VIE reconsideration event — bankruptcy**

Generally, when an entity files for bankruptcy protection, the group of at-risk equity investors lose the power to make decisions that have a significant impact on the economic performance of the entity. Decision making over an entity that is in bankruptcy typically transfers to the bankruptcy court or creditor committee while the entity is in the process of reorganizing or liquidating. Therefore, we believe that the act of filing for bankruptcy typically constitutes a reconsideration event under the VIE model.

Similarly, when an entity emerges from bankruptcy, this would generally represent an event that requires reconsideration of entity’s status as a VIE. This is due to the fact that the entity’s governing documents and contractual arrangements are typically modified in a manner that impacts the sufficiency and characteristics of the entity’s equity investment at risk.

2.3.4.11 **VIE reconsideration event — decision maker/service provider**

As discussed in CG 2.2.4.3, the VIE model does not specify whether the determination of whether a decision maker or service provider arrangement is a variable interest should be reassessed upon the occurrence of a reconsideration event or 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. If such arrangements are evaluated on a continuous basis, a change in the conclusion as to whether the decision maker or service provider’s arrangement is a variable interest could trigger a reconsideration event of the entity as described in ASC 810-10-35-4. If a policy to reassess on a continuous basis is elected, the ongoing assessment should focus on identifying changes that have occurred that would cause the decision maker to begin acting as a principal when it was previously determined to be acting as an agent, or vice versa.

We do not believe the introduction of new terms in similar structures or an increase in new market entrants (which would put downward pressure on fees) would change a service provider’s decision making philosophy (i.e., incentivize the service provider to begin acting in the capacity of a principal). Therefore, absent a modification of the contractual terms, we would not expect a reassessment of the At Market and Commensurate criteria as part of this ongoing reassessment.
We would, however, expect a reporting entity that has made a policy election to reassess its decision maker or service provider fee on an ongoing basis to re-evaluate the significance of its other economic interests at each reporting date. We believe a decision maker should focus on its acquisition of other economic interests, including direct and indirect variable interests, each time this reassessment is performed. In addition, we believe the decision maker should also re-evaluate whether a change in the fair value of its economic interests has occurred since the prior reassessment date. If the fair value of the decision maker’s other economic interests have decreased from significant to worthless, we would view this to be the equivalent of in-substance disposition of that interest.

Conversely, we would view an increase in the fair value of the decision maker’s other economic interest from insignificant to significant as an in-substance acquisition of additional interests. In both cases, we believe these events could change the behavior of the decision maker and potentially causes its decision making philosophy to migrate from that of a principal to an agent, or vice versa.

### 2.4 Identifying the primary beneficiary of a VIE

The primary beneficiary is the reporting entity that is required to consolidate the VIE. The analysis required to determine which entity has a controlling financial interest and is the primary beneficiary of a VIE is predominantly qualitative. 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. A reporting entity is required to reconsider whether it is the primary beneficiary of a VIE on an ongoing basis.

#### 2.4.1 Identification of the primary beneficiary

Once a reporting entity determines that it has a variable interest in a VIE, it must determine whether or not it is the primary beneficiary.

#### 2.4.1.1 What is a primary beneficiary?

A primary beneficiary (PB) is the reporting entity that holds a controlling financial interest in an entity and thus is required to consolidate the VIE. The VIE model requires a reporting entity with a variable interest in a VIE to qualitatively assess whether it has a controlling financial interest in the entity. This approach is intended to encourage the use of judgment in determining which reporting entity controls a VIE.

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**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:

- The power to direct the activities of a VIE that most significantly impact the VIE’s economic performance
- 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.

**ASC 810-10-25-38B**

A reporting entity must identify which activities most significantly impact the VIE’s economic performance and determine whether it has the power to direct those activities. A reporting entity’s ability to direct the activities of an entity when circumstances arise or events happen constitutes power if that ability relates to the activities that most significantly impact the economic performance of the VIE. A reporting entity does not have to exercise its power in order to have power to direct the activities of a VIE.

A reporting entity is deemed to be the primary beneficiary of a VIE 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 meets both the power and the losses/benefits criteria, the VIE’s purpose and design, including the risks the entity was designed to create and pass through to its variable interest holders, should be considered.

Only one reporting entity (if any) should 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 requires an ongoing reconsideration of the primary beneficiary of a VIE. There are many reasons why there could be a change in the primary beneficiary. For example, a change might result from a transfer of power from one reporting entity to another. Some examples of when this might occur include:

- The expiration of kick-out rights or participating rights
- The realization of a contingent event that causes kick-out rights or participating rights to become exercisable
- Acquisition of interests or contractual arrangements that allow a party to exercise power over the entity

Question 2-9 addresses whether a VIE will always have a primary beneficiary.
**Question 2-9**
Will a VIE always have a primary beneficiary?

**PwC response**
Under certain scenarios, none of the variable interest holders may be deemed to be the primary beneficiary and therefore no one would consolidate the VIE. For example:

- The party that meets the power criterion may not hold a potentially significant variable interest in the VIE (i.e., it does not meet the losses/benefits criterion).

- Power is shared among multiple unrelated parties

- Power is not shared, but multiple unrelated parties direct the same activities that most significantly impact the entity’s economic performance, and no single party directs the majority of these activities.

2.4.2  **Primary beneficiary — 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 first identify which activities are significant, and then determine who has the power to direct those activities.

2.4.2.1  **Identifying the activities of a VIE that most significantly impact its economic performance**

Determining which activities most significantly impact a VIE’s economic performance can require significant judgment. First, a VIE’s purpose should be considered, including the risks that it was designed to create and pass along to all of its variable interest holders. Next, the reporting entity should identify the activities of the VIE that significantly impact these risks. The activities of a VIE that give rise to, or stem from these risks generally impact the economic performance of the entity in a significant manner. Lastly, the reporting entity should determine which party has the ability to direct a majority of the activities identified that most significantly impact the VIE’s economic performance.

2.4.2.2  **Decisions that most significantly impact performance**

Once the most significant activities of the VIE have been identified, an analysis should be performed to understand the decisions related to those activities that most significantly impact the VIE’s economic performance. The party who can make decisions that direct a majority of a VIE’s economically significant activities can most significantly impact the VIE’s economic performance. A variable interest holder is not required to have the power to direct all of an entity’s significant activities in order to have power.

The VIE model does not specify how to determine whether one or more activities represent a majority of the VIE's economically significant activities. A careful consideration of the following factors may prove helpful in considering which decisions most significantly impact the VIE’s economic performance:
- How each decision impacts the risks that the VIE was designed to create and pass along to its variable interest holders
- How the decisions impact the cash flows of the VIE
- How the decisions impact operating margins of the VIE
- Whether such decisions could increase the VIE’s revenues
- How the decisions could affect the overall fair value of the VIE
- The nature of the VIE’s assets, and how the decisions could impact the fair value of those assets

In some cases, it may be obvious which activities and decisions most significantly impact a VIE’s economic performance. In other cases, this analysis may be less clear. In those circumstances, judgment should be applied based on the facts and circumstances specific to the VIE, including its purpose and design and the risks it was intended to create and pass along to its variable interest holders.

As discussed in CG 2.3.3.2, an entity’s significant activities must be identified for purposes of determining whether the entity is a VIE under Characteristic 2. As a general matter, we would expect the significant activities of an entity to be the same for both analyses (i.e., the VIE and primary beneficiary determinations). Examples of common significant activities of entities by industry can also be found in CG 2.3.3.2.

2.4.2.3 Impact of financial responsibility in assessing power

The VIE model requires that implicit and explicit financial responsibilities be considered in the primary beneficiary analysis.

**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 a VIE operates as designed requires judgment, including consideration of the entity’s purpose and design. We believe the determination of what constitutes an implicit financial responsibility should consider the likelihood of all potential events.

Although a variable interest holder’s involvement in the design of a VIE is not determinative that it has power over the entity, its involvement may demonstrate that it had the opportunity and incentive to
establish arrangements to provide it with power. Such situations require a careful review of the entity's governing documents to determine whether that variable interest holder truly has power.

If the ongoing decisions of a VIE do not significantly impact its economic performance (i.e., they are purely administrative in nature), then the predetermined decisions made at formation are likely more relevant to the power analysis. Examples of such activities may include the selection of assets to be purchased by the entity, what will occur when the entity is dissolved, and the rights of the various parties. Refer to CG 2.4.3 for further discussion around entities with limited or no ongoing significant activities.

2.4.2.4 Shared power among unrelated parties

In certain situations, the power to direct a VIE’s most significant activities may be shared among unrelated parties. In those situations, no party would be deemed the primary beneficiary of the VIE.

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 ability to direct the activities of a VIE that most significantly impact the VIE’s economic performance. This is often the case when each party is required to consent to decisions relating to those significant activities, assuming the consent requirement is substantive.

This principle is illustrated in the examples included in ASC 810-10-55-182 through ASC 810-10-55-198. In that 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. If two or more unrelated parties are required to vote on (i.e., consent to) all decisions that significantly impact the VIE’s economic performance, power is considered to be shared.

Question 2-10 addresses whether it is possible for a joint venture that is a VIE to not have a primary beneficiary.

Question 2-10

If all parties involved with a joint venture that is a VIE must consent to all decisions that most significantly impact the VIE’s economic performance, would it be appropriate to conclude the VIE does not have a primary beneficiary?

PwC response

It depends. When a joint venture is a VIE and the venture partners are not related parties, no primary beneficiary will exist if all activities that significantly impact the VIE’s economic performance require the consent of the venture partners. If the venture partners are related parties or de facto agents (refer
to CG 2.4.2.5), then one of the venture partners will be required to consolidate the VIE if power over all of the VIE’s significant activities is shared. The evaluation of circumstances where power is shared among related parties is discussed in further detail in CG 2.4.6.1.

Circumstances may arise where some, but not all of a VIE’s significant activities require the consent of two or more unrelated parties. Some have interpreted the term most in ASC 810-10-25-38D to mean majority, thereby suggesting that power is shared when a VIE’s economically significant activities that are responsible for deriving a majority of its economic performance require the consent of two or more unrelated parties.

We believe shared power does not exist unless the consent of each party believed to share power is required for all of the VIE’s most significant activities. Although the consent of two or more unrelated parties may be required for a majority, but not all of a VIE’s most significant activities (e.g., two out of three of the VIE’s significant activities identified), the ability of one party to unilaterally direct a single significant activity may call into question whether power over the VIE is in fact shared.

In those situations, the party with the ability to unilaterally direct the VIE’s other significant activity may wield incremental power relative to the other party or parties believed to share power. This “relative power” model may suggest that the party with the ability to unilaterally direct a single significant activity of the VIE has power over the entity, and may be the VIE’s primary beneficiary.

**Majority consent vs. unanimous consent**

In some situations, the decisions that most significantly impact the economic performance of an entity that is a VIE may require the approval of a majority of the parties involved with the VIE. We believe the unanimous consent of all parties involved is required to demonstrate that power is shared when two or more unrelated parties direct the significant economic activities of the VIE. However, if all of the unrelated parties are required to consent to decisions related to the VIE’s most significant activities, we believe power would be shared.

2.4.2.5 **Related parties – impact on the VIE model**

Related party and de facto agency relationships can play a critical role in the VIE model in two ways: (1) the determination of whether the entity is a VIE, and (2) 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:

**Definition 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.

The VIE model expands the traditional definition of related parties, as described in ASC 850, *Related Party Disclosures*, to include “de facto agents,” which are defined as follows:

**Excerpt from ASC 810-10-25-43**

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 close business relationship like the relationship between a professional service provider and one of its significant clients

The intent of supplementing the traditional definition of related parties in the VIE model by including de facto agents was to prevent a variable interest holder from avoiding consolidation of a VIE by protecting its interest(s) or indirectly expanding its holdings through such 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.
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 (1) are financially dependent on the enterprise; (2) receive the investment or the funds to make the investment from the enterprise; or (3) are an officer, employee, or on the governing board of the enterprise.

The other relationships that create a de facto agent require more judgment. A de facto agency relationship is created when a party cannot sell, transfer, or encumber their interests without the approval of the reporting entity (often referred to as “transfer restrictions”). However, mutual transfer restrictions do not cause a de facto agency relationship if both parties have the right of prior approval and the rights are mutually agreed terms by willing, independent parties. A de facto agency relationship is also created when a party provides significant amounts of professional services or other similar services to a reporting entity (“significant service provider”). Certain de facto agency relationships, including those established as a result of transfer restrictions and close business relationships, are more difficult to apply.

**Transfer restrictions**

Absent the de facto agency rules, a reporting entity could avoid consolidation of a VIE by “parking” its interests with a third party and controlling 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 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, where the reporting entity and the restricted party may be acting in concert. The FASB acknowledged that the evaluation of these types of situations would be heavily dependent on particular facts and circumstances and that judgment would be required to assess 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: (1) whether or not the “restricted” party has the ability to realize (or manage) its economic interest in the entity and (2) 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 the parties have the right of prior approval and the rights 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 only has the right to encumber (pledge) its interest in the entity without prior approval, but the characteristics of the interest do not allow the restricted party to monetize a substantial portion of the interest’s fair value (say, below 80%) through that right, it would be difficult to conclude that the restricted party has the ability to realize the economics of its interest.

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 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” in ASC 810-10-25-43(d) should be applied. For example, should transfer restrictions be applied generically to any circumstance where 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.

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 generally does not create a de facto agency relationship because the variable interest holder is not constrained from managing its economic interest in the entity.
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 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.

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 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) it 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 reasons for which approval can be withheld) and (2) there are a sufficient number of such qualified buyers to provide a non-restricted market. Oftentimes, the assistance of legal counsel is necessary when interpreting the unreasonably withheld provision of the agreement and supporting the entity’s conclusion.

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% 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, Party B is a de facto agent of Party A because there is an unconditional contractual restriction on Party B from selling, transferring, or pledging its interest. Once the lock-up period expires, Party B would no longer be considered a de facto agent, which might result in a change in the primary beneficiary conclusion. Evaluating lock-up periods requires considerable judgment.

Close business relationships

Determining whether a service provider is acting as a de facto agent of a reporting entity can 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 conclusion that close business relationships may create de facto agency relationships was intended to prevent situations in which a portion of a reporting entity’s variable interest could contractually be transferred from a reporting entity to a financial advisor, law
firm, or other service provider, in an attempt to avoid consolidation. 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 of funds through the service provider?

### 2.4.2.6 Two or more unrelated parties direct the same significant activities when power is 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 significant activities will meet the power criterion. However, if no party has power to unilaterally direct a majority of the VIE’s significant activities, then no party will 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 ASC 810-10-55-196. In that example, two unrelated parties are individually responsible for manufacturing, distributing, and selling a product (i.e., the VIE’s significant activities) in different locations, and neither is required to obtain the other’s consent over decisions relating to the significant activities for which it is responsible. If neither party directs a majority of the entity’s significant activities, then neither party would be the VIE’s primary beneficiary.

This principle may also apply when analyzing securitization vehicles for consolidation. For example, three separate parties may be responsible for servicing separate and distinct pools of assets held as collateral by the securitization vehicle.

Consider a situation in which three companies (Company A, B, and C) each perform servicing of the mortgage loans in a mortgage loan securitization. Each company can make servicing decisions independently (i.e., without the consent of any other party). Servicing of the mortgage loans is determined to be the activity that most significantly impacts the economic performance of the VIE. If neither Company A, B, nor C are responsible for servicing a majority of the mortgage loans held by the VIE, then no party may have power over the entity.

Example 2-33 illustrates the evaluation of the impact of a change in power due to the passage of time.
EXAMPLE 2-33
Evaluating the impact of a change in power due to the passage of time

Company A and Company B purchase outputs 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.

Which company would be deemed to meet the power criterion?

Analysis

While both Company A and Company B’s variable interest provide them with the power to direct the significant activities of Company X, 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 the term of its PPA, while Company B will meet the power criterion once Company A’s PPA has expired and Company A no longer has a variable interest in Company X.

2.4.2.7 Two or more unrelated parties direct different significant activities when power is not shared

If the activities that significantly impact the VIE’s economic performance are directed by multiple unrelated parties, and the nature of the activities each party is directing are different, then the reporting entity should identify which party has the power to direct the activities that most significantly impact the VIE’s economic performance (i.e., a majority of the entity’s significant activities). One party will have the ability to direct the most significant activities, and that party will meet the power criterion.

Example 2-34 and Example 2-35 illustrate the impact of multiple unrelated parties concurrently directing different significant activities.

EXAMPLE 2-34
Multiple unrelated parties concurrently direct different significant activities

Fruit Co. and Bottle Co. (unrelated parties) form Juice Co. Both Fruit Co. and Bottle Co. contribute an equal amount of cash and receive a 50% 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.
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. Profits and losses of Juice Co. will be allocated equally to Fruit Co. and Bottle Co. based on their relative ownership percentages. 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?

**Analysis**

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 and distribution network, while providing Bottle Co. access to Fruit Co.’s supply of organic fruit.

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 that 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 these activities.
EXAMPLE 2-35

Multiple unrelated parties concurrently direct different significant activities

Fruit Co. and Bottle Co. (unrelated parties) form Juice Co. Both Fruit Co. and Bottle Co. contribute an equal amount of cash and receive a 50% 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.

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. Profits and losses of Juice Co. will be allocated equally to Fruit Co. and Bottle Co. based on their relative ownership percentages. Apart from their equity interest, neither Fruit Co. nor Bottle Co. holds any other variable interest in Juice Co.

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.

How should Fruit Co. determine if it meets the power criterion?

**Analysis**

In this example, agricultural decisions most significantly impact Juice Co.’s economic performance. Since Fruit Co. unilaterally directs agricultural activities, it would meet the power criterion. Although Bottle Co. directs more significant activities in absolute terms, those activities do not represent Juice Co.’s most significant activities.

**Significant decisions made upon the occurrence of a contingent event**

The analysis to determine which reporting entity has the ability to make the most significant decisions of the entity becomes challenging when one or more of the significant decisions are only made upon the occurrence of a contingent event(s). In addition to considering the purpose and design of the entity and the significant activities of the entity, in making this assessment, the reporting entity should consider the likelihood of the contingent event occurring, including the reporting entity’s ability to influence the occurrence of the contingent events. The greater the likelihood of the contingent event occurring, the more weight should be given to those contingent significant decisions when making the determination as to which reporting entity has the ability to make the most significant decisions. The reporting entity should also consider whether the contingent significant decisions can be made concurrent with other significant decisions of the entity (e.g., servicing of loans and servicing of default loans) or whether the contingent significant decisions can only be made in sequence and are dependent on the success of previous significant decisions (e.g., research and development activities followed by production and marketing activities).

In situations where the contingent significant decisions can be made concurrent with other significant decisions, the assessment of which reporting entity has the power over the most significant decisions of the entity should consider all significant decisions, including the contingent significant decisions and their likelihood of occurring. The reporting entity with the ability to make the most significant decisions of the entity would meet the power characteristic. Because the assessment of power considered all significant decisions, including the contingent ones, there would likely not be a change
in the determination of which reporting entity met the power criterion when the contingencies are resolved.

In situations when the contingent significant decisions are made in sequence and dependent on the success of previous significant decisions, the assessment of which reporting entity has the power over the most significant decisions of the entity should first focus on the likelihood of the contingent significant decisions being made. If it is unlikely, the assessment of the most significant decisions should only consider the current significant decisions until the contingency has occurred. The reporting entity with the ability to make the current significant decisions would likely meet the power characteristic. In these situations, there would likely be a change in the reporting entity with power if a different reporting entity is able to make the significant decisions once the contingency occurs.

Alternatively, if it is likely or relatively certain that the contingent significant decisions will be made, the assessment of the most significant decisions should include all significant decisions, including the contingent ones, in a manner similar to the evaluation of concurrent contingent significant decisions. These assessments are described in:

- Example 2-36, Assessing the impact of activities that are contingent upon a future event
- Example 2-37, Multiple unrelated parties sequentially direct different activities
- Example 2-38, Multiple unrelated parties sequentially direct different activities when there is significant uncertainty
- Example 2-39, Evaluating the impact of a contingent shift in power

**EXAMPLE 2-36**

Assessing the impact of activities that are contingent upon a future event

A VIE is created for the purpose of purchasing commercial mortgage loans from a third party transferor. The VIE finances the purchase of the commercial mortgage loans by issuing fixed rate debt to third party investors, and equity to a third party that will also perform special servicing. The transferor retains primary servicing responsibilities over the mortgage loans. Upon the occurrence of a default of a mortgage loan, the administration of the loan is transferred to the special servicer.

Which party has the power to direct the activities of the VIE that most significantly impact its economic performance?

*Analysis*

In this example, the VIE's activities that most significantly impact its economic performance involve the management of assets that go into default, which is the responsibility of the special servicer. Although the special servicer cannot exercise power over this activity until a contingent event occurs (i.e., the default or delinquency of the mortgage loans held as collateral), the special servicer would likely be deemed to have power as this activity has the most significant impact on the economic performance of the VIE.

The special servicer would be deemed to have power because the activity of managing assets that go into default is likely to occur and can also occur concurrent with all other significant activities.
Therefore, this activity is included in the assessment of which activities most significantly impact the economic performance of the entity.

**EXAMPLE 2-37**

**Multiple unrelated parties sequentially direct different activities**

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 a 50% equity interest in the entity, which was 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). 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 were obtained to construct the facility. In addition, Company B was able to begin manufacturing and selling the finished product in accordance with the entity's original business plan.

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 interests in the VIE.

**Which party would be deemed to meet the power criterion?**

**Analysis**

In this example, the variable interest holder that meets the power criterion during and after the construction phase 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.

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 life cycle of the entity (even during the construction phase) since the activities over which it has power (manufacturing and sales) are key drivers of the entity’s economic performance. Even though the significant activities are sequential and the manufacturing and sales activities are dependent on the successful completion of the construction activities, both significant activities should be included in the assessment of which reporting entity has the ability to make the most significant decisions of the entity.

If, on the other hand, significant uncertainties existed with respect to the construction (e.g., zoning and design issues) and/or Company A did not have a positive historical experience in successfully completing similar projects, Company A may be deemed to meet the power criterion during the construction phase with the power shifting to Company B at or near completion. In this case, only the construction activity would be included in the initial assessment of which reporting entity has the ability to make the most significant decisions of the entity since there is significant uncertainty about the completion of the construction phase of the project.
EXAMPLE 2-38
Multiple unrelated parties sequentially direct different activities when there is significant uncertainty

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 plans to perform further research and development in order to obtain approval from the FDA for commercialization of the drug. The drug is currently in Phase I clinical trials and there is significant uncertainty regarding the likelihood of the drug reaching FDA approval.

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 once FDA approval is received, 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.

Which party would be deemed to meet the power criterion?

Analysis

Both Company A and Company B have the power to direct significant activities of the VIE that will impact its economic performance. However, Company B’s power is contingent upon the successful development of the drug and receipt of the required approvals.

Since there is significant uncertainty regarding FDA approval at the assessment date, and the manufacturing, marketing, and distribution activities are sequential and dependent on the success of the FDA approval activities, the determination of power should be based on the significant activities that exist during the initial stage (i.e., FDA approval activities). Therefore, it is likely that Company A would meet the power criterion during the initial stage since it has the power to direct the activities that will have a significant impact on the VIE’s economic performance.

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.

EXAMPLE 2-39
Evaluating the impact of a contingent shift in power

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 and holder of the residual interest retain servicing responsibilities over the mortgage loans. Upon a substantive predefined event of default (which is triggered based upon a significant amount of delinquencies of the underlying assets), FG Company has the right to remove the transferor and assume the role of servicer.
Which party would be deemed to meet the power criterion once the predefined event of default is triggered?

Analysis

As servicer, the transferor is responsible for servicing the non-performing loans, which includes contacting borrowers in default, 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, would meet the power criterion.

However, once the predefined event of default is triggered, FG Company would meet the power criterion. FG Company would be deemed to meet the power criterion because it would have the ability to replace the transferor as servicer at any time once the predefined event of default is triggered. As a result, there would be a change in the party with power.

2.4.2.8 Power — board governance and separate venture partner contract

If an entity is governed by a board of directors and one of the venture partners has the ability to make decisions through a separate arrangement (e.g., a management contract, managing member interest, or general partner interest), an analysis should be performed to determine at what level power is exercised (i.e., by the VIE’s board of directors or the manager). To make this determination, a reporting entity should consider, among other things, the following:

- At what level the significant decisions of the VIE are made
- At what level the significant activities of the VIE are carried out
- Whether the board makes decisions at a granular level, thereby establishing narrow parameters that the manager must operate within when carrying out decisions made by the board
- Whether decisions made by the board are at a high level, thereby giving the manager significant latitude and discretion in carrying out such decisions
- If the board directs the entity’s most significant activities, whether each party is required to consent to decisions made by the board that relate to the VIE’s significant activities

If the entity’s significant operating and capital decisions are made by the board, then the manager would not have power. In such cases, the manager would generally have limited authority as to how such decisions are carried out. In other words, the manager would be acting as an agent of the board. This is often the case when decisions made by the board are detailed and narrow parameters are specified as to how such decisions should be implemented.

Alternatively, if decisions made by the board are very high level in nature and the manager (1) makes decisions that most significantly impact the entity’s economic performance, or (2) has significant discretion carrying out decisions made by the board, then the manager may have power.
This analysis becomes more challenging when the VIE outsources decision making to one of the venture partners through a separate contractual arrangement. In such situations, an analysis must be performed to determine whether that venture partner is able to exercise power over the entity.

Example 2-40 illustrates the determination of whether power is shared through an entity’s board of directors when an entity’s day-to-day operations are managed by one of the venture partners.

**EXAMPLE 2-40**

Determining whether power is shared through an entity’s board of directors when an entity’s day-to-day operations are managed by one of the venture partners

Company A and Company B, unrelated parties, form a new entity, Company X. Company X is governed by its board of directors, which consists of four directors, two appointed by each party. All significant decisions of Company X are made by its board of directors and require the consent of both Company A and Company B.

Company X also entered into a contractual arrangement with Company B to manage Company X’s day-to-day operations. Company B’s decision making ability is limited to carrying out operating decisions approved by Company X’s board. Company X’s board is actively involved in overseeing the operations of Company X. The board’s decisions are very specific and its operating and capital budgets are prepared and approved at a very granular level. Company B is not able to unilaterally direct any of Company X’s significant activities through the management agreement.

Does Company B meet the power criterion by virtue of its separate management agreement?

*Analysis*

No. The significant decisions of Company X are made by its board of directors. In addition, these decisions are made at a very detailed, granular level. Since Company B’s day-to-day operating activities are limited to carrying out the significant decisions made by the board and Company B is not able to unilaterally direct any of the board’s decisions, Company B does not have power. Rather, power would be considered shared since the board has power and any significant decisions made by the board require the consent of both Company A and Company B.

In many situations where the consent of two or more parties is required in order for an entity to make a decision, the governing documents contain dispute resolution provisions clarifying what process will be undertaken if a “deadlock” occurs (i.e., when the parties are unable to agree on a specific decision or course of action). If one of the parties has the ability to break the deadlock by casting a tie-breaking vote, it may be deemed to have the power over the entity and power would not be considered shared.

**2.4.2.9 Decision making is outsourced through a third party contract**

There may be circumstances where a single decision maker has the ability to direct the activities of the VIE that most significantly impacts its economic performance through a management or services contract. If the decision making contract does not qualify as a variable interest, then the decision maker or service provider should be presumed to be acting in an agency capacity on behalf of the VIE’s interest holders. In other words, the decision maker or service provider would not have power because it is acting in a fiduciary capacity. Refer to CG 2.4.4 for further detail regarding the evaluation of decision maker or service provider fee arrangements.
In such cases, we believe the VIE's at-risk equity investors would have the power to direct the VIE's most significant activities. If a single holder of equity at risk has a majority voting interest, we believe that party may have power absent the existence of substance participating rights. In the absence of a single at-risk equity investor that has the ability to unilaterally exercise power through its voting rights, we believe there would be no primary beneficiary.

Example 2.41 illustrates the assessment of outsourced decision maker arrangements when the fee does not represent a variable interest.

**EXAMPLE 2.41**

Assessing outsourced decision maker arrangements when the fee does not represent a variable interest

Reporting Entity A is a servicer to a VIE that is a securitization vehicle that issued beneficial interests collateralized by mortgage loans. In addition to its contractual arrangement to act as servicer to the VIE, Reporting Entity A also holds a small senior interest in the VIE. Reporting Entity A determined it has "power" to make decisions that most significantly impact economic performance of the VIE through its servicing contract. Reporting Entity A has determined that its service contract is not a variable interest despite the senior interest it holds in the entity when assessing under ASC 810-10-55-37 (see CG 2.2.4).

**Analysis**

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.

**2.4.2.10 Disproportionality – stated power vs. economic exposure**

In some cases, a variable interest holder may lack stated power while holding an economic interest in a VIE that exposes that variable interest holder to greater than a majority of the VIE's benefits and losses.

**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 calls for increased skepticism in these situations. As the level of disparity between a variable interest holder's level of stated power and exposure to benefits and losses increases, so too should a reporting entity's level of skepticism around the substance of that variable interest holder's apparent lack of stated power. In these situations, judgment should be applied and a detailed understanding of the facts and circumstances will be necessary.
2.4.3 **VIEs with limited or no ongoing significant activities**

Highly structured entities with limited activities (e.g., securitization vehicles and special purpose entities) may be established with all key decisions predetermined at formation. The remaining activities conducted by the VIE throughout its life may be limited to activities that are purely administrative in nature (e.g., collecting and distributing cash to the interest holders). When such activities do not significantly impact the economic performance of the VIE, questions may arise as to which party, if any, has power over the VIE.

If a VIE was established to have a limited life with no significant ongoing decision making requirements, we believe the power analysis should focus on the key decisions of the VIE that were made at formation (or upon the redesign of the entity). Determining which variable interest holder, if any, has power requires consideration of the purpose and design of the VIE, including each party’s involvement in determining the VIE’s activities and how those activities will be carried out. A variable interest holder’s involvement in the design of the VIE may indicate that it had the opportunity and incentive to establish arrangements through which it can exercise power over the VIE. We believe a variable interest holder’s incentive to establish arrangements through which it can exercise power will be greater as its exposure to the VIE’s benefits and losses increases.

When a VIE’s ongoing decision making relates to activities that significantly impact the economic performance of the VIE, an analysis should be performed to determine which party has the ability to direct such activities. In circumstances where the VIE’s ongoing activities are limited to a single significant activity, we believe the party with power over that activity would likely meet the power criterion, although each variable interest holder’s involvement in the design of the VIE should also be considered.

The analysis described above should consider each variable interest holder’s current ability to exercise power, even though they may not actively do so.

### 2.4.3.1 **Assessing rights held by non-decision makers**

In some circumstances, rights held by other variable interest holders should be considered to determine whether such rights convey power (kick-out or liquidation rights) or prevent a decision maker from exercising power (participating rights).

**Impact of kick-out rights in assessing the power criterion**

A reporting entity’s determination of whether it meets the power criterion should not be impacted by the existence of kick-out 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 as follows:
**Definition from ASC 810-10-20**

Kick-Out Rights (VIE definition): The ability to remove the entity with the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance or to dissolve (liquidate) the VIE without cause.

**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.

A decision maker’s ability to exercise power over a VIE cannot be overcome through kick-out rights unless a single variable interest holder (including its related parties and de facto agents) can exercise a substantive kick-out right. If two or more unrelated parties are required to come together to exercise the kick-out right, it would not impact the power assessment. This definition and threshold differ from the definition and threshold used to assess whether a limited partnership is a VIE under Characteristic 2, and also the voting model as described in CG 3.5.2.

Example 2-42 illustrates the evaluation of whether a kick-out right is substantive in the primary beneficiary analysis.

**EXAMPLE 2-42**

Evaluating whether a kick-out right is substantive in the primary beneficiary analysis

A limited partnership was formed to develop and operate a mixed use property. The general partner owns 12% of the outstanding partner interests, and the remaining 88% limited partner interests are held by third party investors. The partners will fund their capital commitments over time as the property is constructed. Because the equity at risk was not sufficient to develop and operate the property, the LP was determined to be a VIE under Characteristic 1.

Although the general partner has the power to direct a majority of the VIE’s economically significant activities, the limited partners, through a simple majority vote, have the substantive ability to replace the general partner anytime without cause.

Does the kick-out right held by the limited partners demonstrate that the general partner lacks the power to direct the VIE’s most significant activities?

**Analysis**

No. If a single party has the power to direct a VIE’s most significant activities, that power can be overcome by a kick-out right only when that kick-out right is currently exercisable by a single variable interest holder (including its related parties and de facto agents). Since this kick-out right in this
example requires the affirmative vote of a simple majority of the limited partners, it would not be considered substantive and the general partner would be deemed to have power over the entity.

Question 2-11 addresses whether a board of directors with the ability to exercise a kick-out right should be viewed as a single party for purposes of evaluating whether the kick-out right is substantive.

**Question 2-11**

If a kick-out right is exercisable by an entity’s board of directors, can the board be viewed as a single party when evaluating whether the kick-out right is substantive?

**PwC response**

In virtually all cases where multiple shareholders exist, a board of directors will not be viewed as a single party. A board is typically comprised of two or more individuals that have a fiduciary responsibility to the entity’s shareholders (i.e., the board should be viewed as a proxy for the shareholder group). The ability of the board to exercise a substantive kick-out or liquidation right should be viewed as if that right was exercisable directly by the shareholder group. Therefore, the ability of a board to exercise kick-out or liquidation rights will not influence which party, if any, has power unless a single party (and its related parties and de facto agents) has unilateral control over the board.

Example 2-43 illustrates the evaluation of a purchase and sale agreement with a non-refundable deposit.

**EXAMPLE 2-43**

Evaluating a purchase and sale agreement with a non-refundable deposit

Company A (reporting entity) enters into a purchase and sale agreement with Company X (entity) under which Company A will buy land and a building from Company X, its sole assets. 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 2-9 for details), and that Company X is a VIE (see Question 2-7 for details), will Company A be considered to meet the power criteria due to its non-refundable deposit to Company X?

**Analysis**

Potentially. Company A will need to assess whether it 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. 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 direct 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 the buyer would meet the power criteria.
Evaluating whether a kick-out right is substantive

A kick-out right may convey power over an entity’s most significant activities if that right allows the holder to permanently strip the decision maker of its decision making authority. We believe kick-out rights convey power over an entity only when the kick-out right is substantive. Although ASC 810-10-25-38C does not specifically state that a kick-out right must be substantive to influence which party has power over an entity, we believe the following overarching concept of ASC 810-10 supports this view:

ASC 810-10-15-13A

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

a. A legal entity’s status as a variable interest entity (VIE)

b. A reporting entity’s power over a VIE

c. A reporting entity’s obligation to absorb losses or its right to receive benefits of the legal entity

In making the evaluation of whether a kick-out right is substantive, we believe a determination should be made as to whether there are any barriers to exercising such rights, such as the following:

□ 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

□ 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

In addition, a reporting entity should consider whether another variable interest holder has a substantive participating right (refer to CG 2.3.3.2). If a single party has a substantive participating right, that right would prevent the holder of the kick-out right from exercising power (i.e., regardless
of which party serves as the decision maker, the party with the participating right will have the ability to block decisions related to all of the entity's most significant activities).

The above list is not all inclusive, and the facts and circumstances of each situation should be carefully considered.

**Liquidation rights**

The definition of a kick-out right also includes the ability to dissolve (liquidate) a VIE without cause. Accordingly, a single party (including its related party and de facto agents) with the ability to liquidate a VIE would meet the power criterion if that right is substantive.

The guidance is view is based on the notion that a single party’s ability to liquidate a VIE produces the same outcome as exercising a kick-out right. That is, the decision maker will be permanently stripped of its decision making rights. The ability of the investors to obtain substantially all of the same specific assets under management and to find a replacement manager with sufficient skills to manage those assets is not relevant to the evaluation of a liquidation right.

As discussed in CG 2.3.3.2, we believe redemption rights are legally and economically different from liquidation rights. That is, a redemption right represents an obligation to return capital to an investor at the investor’s request. If an investor exercises its redemption right, it generally will be unable to strip the decision maker of its power over the entity. Therefore, redemption rights should generally be disregarded when assessing the power criterion.

There may be certain cases where a redemption right is not substantively different from a liquidation right. This could be the case when a VIE has a single investor that could force a liquidation of the entity upon exercising its redemption right.

**Impact of participating rights in assessing the power criterion**

Participating rights are defined as the ability to block or participate in the actions through which a decision maker exercises the power to direct the activities of a VIE that most significantly impact the entity’s economic performance.

**Definition from ASC 810-10-20**

Participating Rights (VIE definition): The ability to block or participate in the actions through which an entity exercises the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance. Participating rights do not require the holders of such rights to have the ability to initiate actions.

Participating rights 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 unless the following conditions are met:

- The participating right is exercisable by a single variable interest holder (including its related parties and de facto agents)
The participating right gives the holder the ability to veto all decisions related to the VIE’s most significant activities (i.e., a majority of the activities that most significantly impact that VIE’s economic performance).

Like a kick-out right, participating rights should be considered when assessing the power criterion only when they are substantive. Question 2-12 addresses the impact of having the ability to exercise a substantive participation right may have on meeting the power criterion.

**Question 2-12**

If a single party has the ability to exercise a substantive participating right, would that variable interest holder meet the power criterion?

**PwC response**

No. Unlike a kick-out right, a participating right does not convey power. A participating right can only prevent another party from exercising power. This distinction is driven by the fact that a participating right limits the holder to vetoing, blocking, or participating in an action as opposed to initiating an action. For that reason, a substantive participating right will only prevent another party from having power.

The definition or threshold used to evaluate whether participating rights are substantive in the VIE model is not aligned with the voting model. Consequently, the impact of a participating right may produce different consolidation results under the VIE and voting models. See further discussion in CG 3-5-3.

Unlike a participating right, a protective right allows the holder to block or veto a decision or activity that is expected to occur outside the ordinary course of business (i.e., fundamental changes in the activities of an entity). Therefore, protective rights do not impact the power assessment as such rights are designed to protect the interest of the party holding the right(s).

**Definition from ASC 810-10-20**

Protective Rights (VIE definition): 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.

Determining whether a right is protective or participating is judgmental. Refer to CG 2.3.3.2 for further discussion.

_Evaluation of call options in assessing the power criterion_

Call options (i.e., the right to purchase the equity interests held by an investor of an entity) are common in joint ventures and other types of co-investment structures. For example, one investor in a joint venture may grant another investor the right to purchase its equity interest for a fixed price, at fair value, or at a price determined based on a formula (i.e., a purchased call option from the option holder’s standpoint). As a result of the exercise, the holder (purchaser) of the call option may receive sufficient shares or equity to gain power over the entity.

Call options that require the writer of the option to deliver cash at settlement (net cash settled call options) do not convey power. The holder of the option will not gain the power to direct the activities that most significantly impact the VIE’s economic performance upon settlement of the option. Therefore, net cash settled call options should be disregarded when performing the power assessment.

The VIE model does not specifically address how physically settled purchased call options that give the holder of the call the ability to exercise power over the VIE upon exercise should be considered. The ensuing discussion assumes the call option will be physically settled such that the shares underlying the option would allow the holder to exercise power over the VIE upon exercise of the option and delivery of the shares. When evaluating whether the call option conveys power to the holder, the analysis should consider the voting rights exercisable through the shares underlying the option, as well as any other rights that may inure to the holder upon exercising the option. While there are similarities between kick-out rights and call options, the holder of a call option is generally required to make a significant cash investment to exercise the option. Therefore, we believe call options are economically different from kick-out rights, except in cases where the cash investment is minimal (e.g., call options exercisable at a nominal strike price).

Call options should be carefully considered to determine if they provide the holder with power over the entity. If the call option 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, 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 on a fixed amount or an amount derived by a formula, the intrinsic value of the option should be considered. If the call option is deep in the money, the substance of the arrangement may provide the holder of the call option with power over the entity.
The overall level of control held by the holder of the option. The holder may have the ability to make decisions that most significantly impact the economic performance of the VIE through other variable interests held by the option holder (including its related parties/de facto agents).

Barriers to exercise the option. Factors that could prevent or limit the ability of the option 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 the call option.

Conditions that make exercise not prudent, feasible, or substantially within the control of the holder. For example, when the counterparty to the call option (i.e., the writer of the option) controls technology that is critical to the VIE or is the principal source of funding for the VIE.

The shares received as a result of the exercise of a purchased net share settled call option may provide the holder with power over the entity. When a net share settled option is exercised, it does not require any investment or outlay of cash by the holder. In these cases, the option holder often already has a sizeable investment in the entity.

When the holder of a call option is precluded from exercising the option until a future date (e.g., after 5 years) or a specific event occurs, the call option should not be considered when assessing the power criterion until it becomes exercisable. Both of these scenarios underscore the importance of performing an ongoing primary beneficiary analysis.

### Primary beneficiary — losses/benefits criterion

If a reporting entity has met the power criterion, it will need to determine whether it has the obligation to absorb losses or the right to receive benefits from the VIE that could potentially be significant to the VIE. A reporting entity must meet both the power criterion and the losses/benefits criterion to be the primary beneficiary of the VIE.

#### Losses/benefits criterion — qualitative analysis

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 does not have to be based on a quantitative expected loss/expected residual return calculation. Rather, this assessment is intended to be a qualitative judgment that considers all facts and circumstances, including the terms and characteristics of the variable interest(s), the design and characteristics of the VIE, and other involvement that the reporting entity may have with the VIE.

This qualitative analysis should consider all variable interests held by the reporting entity and other variable interest holders that are involved with the VIE. If the reporting entity has other forms of involvement with the VIE that were not deemed variable interests, those relationships should be ignored when assessing the losses/benefits criterion.

#### Losses/benefits criterion — potential to be significant

All scenarios, irrespective of probability, should be considered in assessing whether the right to receive benefits or the obligation to absorb losses could be potentially significant to the VIE. Even when a reporting entity concludes that it is remote that it will be exposed to benefits or losses that could potentially be significant to the VIE, it would meet the losses/benefits criterion given the requirement to consider all possible scenarios.
Although a reporting entity may not have obligations or rights that are currently significant, its variable interest may provide it with obligations or rights that may become significant to the VIE in the future even under seemingly improbable scenarios. These considerations are 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.

### 2.4.4.3 Losses/benefits criterion — significance

Over time, the FASB has received requests for additional guidance on the losses/benefit criterion, specifically in interpreting “potentially significant to the VIE.” The FASB continues to reaffirm its decision not to provide additional guidance for fear such guidance would provide “bright lines” that would be used inappropriately in practice as the sole factor when determining whether obligations or rights could potentially be significant to the VIE. Determining whether the losses/benefits of a VIE that are absorbed/received by a reporting entity could potentially be significant to a VIE can be judgmental and should be based on the individual facts and circumstances presented.

Examples illustrating the factors that should be considered when identifying the party that is the primary beneficiary are discussed in ASC 810-10-55. These examples do not explicitly state how a reporting entity should determine whether or not it has the obligation to absorb losses or the right to receive benefits that could potentially be significant to the VIE. The guidance provided does, however, confirm that all variable interests should be considered when making this determination.

We have observed reporting entities develop policies regarding how to assess when an economic interest in a VIE is potentially significant. Some reporting entities have established a policy that ownership of an interest that could potentially expose a variable interest holder to benefits and losses of 5% or less is not significant. When the variable interest(s) being evaluated potentially expose the holder to benefits and losses between 5% and 10%, we believe this could potentially be significant depending on facts and circumstances.

A decision maker must consider whether the significance of its other economic interests cause its fee to be a variable interest. If the decision maker’s other economic interests are more than insignificant, its decision maker or service provider fee is a variable interest. In contrast, a decision maker is the primary beneficiary of a VIE if its economic interest is potentially significant.

In circumstances where a variable interest(s) exposes the holder to 10% or more of a VIE’s potential benefits and losses, we have observed very few instances where the reporting entity concluded such interests were not potentially significant. Further, because the concept of “other than insignificant” is probability based and the concept of “potentially significant” is possibilities based, all other than insignificant interests will be potentially significant.

The following factors may be helpful when qualitatively assessing whether a variable interest is potentially significant:

- The overall purpose and design of the VIE, including the risks and rewards the VIE was designed to create and pass along to its variable interest holders. For example, the primary risks and sources of the VIE’s variability should be considered.

- The terms of the VIE’s interests and capitalization structure, including the risks absorbed and the rewards received by each variable interest holder. For example, it is more likely that a variable
The percentage of the class of interest held by the reporting entity. As the reporting entity’s ownership of a class of interests issued by a VIE increases, it may become more likely that its variable interest is potentially significant. The reporting entity should also consider whether it holds a “vertical slice” or a “horizontal slice” of the financing or capital structure of the VIE. For example, consider a VIE with two classes of equity, common stock and preferred stock. If a reporting entity owned only a portion of the preferred stock it would be deemed to have a horizontal slice of the capital structure. On the other hand, if the reporting entity owned identical portions of both the common and the preferred stock it would be deemed to own a vertical slice of the capital structure. Vertical investments may allow for larger overall investments compared to horizontal investments, while not triggering a potentially significant variable interest. For example, consider a 9% interest in both the preferred and common stock. This would represent a 9% overall interest in the entity and would typically not be considered potentially significant. In contrast, assume the preferred stock represented 30% of the total entity capital, a 12% holding of the preferred stock would be considered potentially significant even though that investment represented only 3.6% of the entity as a whole. In some cases, a variable interest holder may own a 100% equity interest in a VIE, but that equity interest may be small in comparison to the VIE’s overall capitalization. While that investor’s exposure to losses may be limited to the amount invested, it has the ability to receive benefits from its equity investment that could potentially be significant to the VIE.

2.4.4.4 Decision maker or service provider fee arrangements

If a decision maker or service provider’s fee arrangement qualifies as a variable interest, its fees may be excluded from the losses/benefits criterion if the arrangement meet conditions (a) and (b) of ASC 810-10-25-38H. These criteria require the fee arrangement to be “at market” and “commensurate.” As discussed in CG 2.2.4.1, we believe a fee arrangement is presumed to be at market and commensurate unless the following factors exist:

- The VIE’s investor base does not include substantive third party investors, and/or
- In addition to its fee arrangement, the decision maker has another variable interest that is unique (i.e., dissimilar from the variable interests held by the other investors).

When a fee arrangement cannot be presumed to be at market and commensurate, additional analysis may be necessary. ASC 810-10-25-38I indicates that a reporting entity should compare the arrangement being evaluated to similar arrangements between third parties. This comparison may not be possible if (1) the fee arrangement relates to a unique or new service (i.e., no comparable arrangements could be identified), or (2) the fee reflects a change in what is considered customary.

When the arrangement is designed to expose the decision maker to a principal risk of loss, the arrangement would not be eligible for exclusion from the losses/benefits criterion. The following list, which is not intended to be all inclusive, provides examples of fee arrangements that are prohibited from qualifying for this exclusion:

interest holder’s right to benefits would be considered significant if the rights had unlimited “upside” (e.g., through a residual interest in the entity), whereas they may not be significant in the case of a senior interest that earns a fixed return and has no right to participate in the entity’s earnings beyond that fixed return. It’s important to note that every type of interest of a VIE could be potentially significant, depending on its terms, including a senior interest.
Fee arrangements where a portion of the fee relates to guarantees of the value of the VIE’s assets or liabilities that the decision maker has provided

Obligations to fund operating losses

Payments associated with written put options on the VIE’s assets

Similar obligations, such as some liquidity commitments or agreements (explicit or implicit) to protect holders of other variable interests from suffering the VIE’s losses.

2.4.5 Indirect interests held through related parties

A reporting entity that meets the power test should consider its direct interests in the VIE together with its indirect interests in the VIE held through its related parties when determining whether it meets the losses/benefits criterion on a stand-alone basis.

Excerpt from ASC 810-10-25-42

Single Decision Maker – The assessment in this paragraph shall be applied only by a single reporting entity that meets the characteristic in paragraph 810-10-25-38A(a). For purposes of determining whether that single reporting entity, which is a single decision maker, is the primary beneficiary of a VIE, the single decision maker shall include all of its direct variable interests in the entity, and, on a proportionate basis, its indirect variable interests in the entity held through related parties (the term related parties in this paragraph refers to all parties as defined in paragraph 810-10-25-43).

A single decision maker will have an indirect interest in a VIE only when that single decision maker holds a direct variable interest in a related party that in turn holds a variable interest in the VIE (i.e., a variable interest through its related party). This differs from the manner in which variable interests held by commonly controlled related parties are considered in the variable interest determination. Such interests would be attributed to the decision maker irrespective of whether the decision maker holds a variable interest in that commonly controlled related party. Refer to CG 2.2.4.2 for recent changes to this guidance resulting from ASU 2018-17.

Under the amendments in ASU 2018-17, such consideration for indirect interests held by commonly controlled related parties were conformed to how they are treated for related parties not under common control (e.g., on a proportionate basis). See CG 2.2.4.2 for further information on ASU 2018-17.

If a single decision maker has an indirect interest in a VIE through a related party, its indirect interest should be calculated based on its proportionate share of its related party’s variable interest. This analysis can be complex when the interests held by the decision maker and/or its related parties are other than “plain-vanilla” common equity. In some instances, a reporting entity may be required to perform a quantitative analysis to derive its proportionate indirect interest if it is unable to qualitatively conclude whether its total economic interest (direct and indirect) is potentially significant.

Related parties to be considered include those defined in ASC 850, Related Party Disclosures, as well as parties deemed to be “de facto agents” under the VIE guidance (ASC 810-10-25-43) as discussed in CG 2.4.2.5. Unlike the analysis required when evaluating whether a decision-making fee arrangement
is a variable interest, indirect interests held by employees and employee benefit plans should be included in the indirect interest assessment.

Example 2-44 illustrates the evaluation of whether a single decision maker has an indirect interest when determining the primary beneficiary of a VIE.

**EXAMPLE 2-44**

Evaluating whether a single decision maker has an indirect interest when determining the primary beneficiary of a VIE

A GP has a 2% general partner interest in a limited partnership that is a VIE. The GP also has a 40% equity interest in a related party that has a 30% limited partnership interest in the limited partnership. The GP is the single decision maker of the limited partnership.

What is the indirect interest that should be considered in determining the primary beneficiary?

**Analysis**

Since, in addition to its direct interest in the VIE, the GP has a direct equity interest in the related party and the related party has a direct equity interest in the VIE, the GP is also deemed to have an indirect interest in the VIE. The GP would have an indirect interest of 12% (40% x 30%) in the VIE for purposes of determining whether it is the primary beneficiary.

**2.4.6 Related party considerations — stand-alone primary beneficiary does not exist**

As discussed in CG 2.4.2, a reporting entity must first determine whether it meets power and losses/benefits criteria on a stand-alone basis. Only if the reporting entity does not meet both criteria on a stand-alone basis should it consider other variable interests held by its related parties to determine whether it is part of a related party group that collectively meets both characteristics of a primary beneficiary. If this is the case, a reporting entity should assess whether a party within that related party group should consolidate the VIE.

**2.4.6.1 Shared power among related parties**

In certain situations, the power to direct a VIE’s most significant activities may be shared among related parties. In those situations, the related party tiebreaker should be applied to determine which party within the related party group is required to consolidate the VIE.

**Excerpt from 810-10-25-44**

The guidance in this paragraph shall be applicable for situations in which the conditions in paragraph 810-10-25-44A have been met or when power is shared for a VIE. In situations in which a reporting entity concludes that neither it nor one of its related parties has the characteristics in paragraph 810-10-25-38A but, as a group, the reporting entity and its related parties (including the de facto agents described in the preceding paragraph 810-10-25-43) have those characteristics, then the party within the related party group that is most closely associated with the VIE is the primary beneficiary.
In situations where power over an entity’s most significant activities is shared among related parties, a qualitative analysis is required to determine which party within the related party group is most closely associated with the VIE. The party within the related party group that is most closely associated with the VIE is the primary beneficiary and is required to consolidate and disclose the impact of the VIE. Refer to CG 2.4.7.2 for further discussion related to the application of the related party tiebreaker test.

If no single party within the related party group has stated power, and a VIE’s significant activities require the consent of two or more related parties, a reporting entity must assess whether power is shared. As discussed in CG 2.4.2.7, shared power exists only when the unanimous consent of all parties believed to share power over a VIE’s economically significant activities is required. This concept is illustrated in Example 2-45.

**EXAMPLE 2-45**

**Shared power among related parties – equal equity ownership**

ABC Co., DEF Co., and XYZ Co., all related parties, each hold a variable interest in Oak Co., a manufacturer of oak furniture for wholesale distribution to retail furniture stores. Each party holds 33% of Oak Co.’s equity and obtained its equity interests in exchange for contributions of cash upon formation of Oak Co. All profits and losses of Oak Co. are allocated to the equity investors pro rata in accordance with their equity interests. Apart from their equity interests, neither party holds any other variable interests in Oak Co.

The board of directors is comprised of six directors—two each appointed by ABC Co., DEF Co., and XYZ Co. 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). Without the ability to exercise two-thirds of Oak Co.’s voting rights, no single equity investor has the power to direct Oak Co.’s activities that most significantly impact its economic performance.

Oak Co. has determined that the activities that most significantly impact Oak Co.’s economic performance are:

- Purchasing raw materials
- Manufacturing
- Sales of oak furniture

Is the power to direct Oak Co.’s most significant activities shared among ABC Co., DEF Co., and XYZ Co.?

**Analysis**

No, power over Oak Co. is not shared because the decisions related to Oak Co.’s most significant activities do not require the *unanimous* consent of all equity investors, acting through their representation on Oak Co.’s board of directors. In order for power to be shared, the significant activities would require the approval of all equity investors. Even though the three equity investors are related and as a group would meet the characteristics of a primary beneficiary, the related party tiebreaker test would not be applied since power is not shared and the three equity investors are not under common control.
2.4.6.2 Common control groups that meet both characteristics of a primary beneficiary

If the related party group has both characteristics of a primary beneficiary and is under common control, then the "related party tiebreaker" test should be performed to identify the variable interest holder within that related party group that is "most closely associated" with the VIE. The party that is most closely associated with the VIE should consolidate the VIE.

The term "common control" is not defined within U.S. GAAP. ASU 2015-02's basis for conclusions indicates that the FASB's intent was for subsidiaries controlled (directly or indirectly) by a common parent, as well as a subsidiary and its parent, to be considered a common control group. When determining whether a related party group is under common control, we believe a parent entity should have a controlling financial interest over the related parties involved. A controlling financial interest is generally defined as ownership of a majority voting interest by one entity, directly or indirectly, or more than 50% of the outstanding voting shares of another entity, with certain exceptions. A controlling financial interest would also exist if the parent entity consolidates its subsidiaries based on the provisions in the VIE model. Refer to BCG 7 for further discussion related to common control transactions.

We do not believe the parent entity must be a legal entity in order for a common control group to exist. That is, a parent could be a natural person that holds a controlling financial interest in various entities.

Example 2-46 illustrates the determination of whether a commonly controlled related party group meets both characteristics of a primary beneficiary.

**EXAMPLE 2-46**

Determining whether a commonly controlled related party group meets both characteristics of a primary beneficiary

Subsidiary A and Subsidiary B are under common control of their parent, Reporting Entity X. Subsidiary A is the general partner and decision maker of Partnership Y, whereby it owns a 1% general partner interest and receives a management fee that is considered at market and commensurate. Subsidiary A does not hold any other interest in the partnership. Subsidiary B has 60% of the partnership’s limited partner interests. The other limited partner interests are held by unrelated parties. Neither Subsidiary A nor Subsidiary B has an interest in each other. As the limited partners do not have substantive kick-out or participating rights over the general partner, the Partnership is determined to be a VIE.
Does the commonly controlled related party group meet both characteristics of a primary beneficiary?

Analysis

Subsidiary analysis

No. Subsidiary A’s 1% general partner interest would not be considered more than insignificant and the management fee is at market and commensurate. Therefore, Subsidiary A does not have a variable interest in Partnership Y (unless it was determined that the partnership was structured to separate power and economics in an attempt to avoid consolidation). As a result, Subsidiary A is considered to be operating in an agency capacity and does not meet the power criterion. While Subsidiary B’s 60% limited partner interest is a potentially significant economic interest that would allow it to meet the losses/benefits criterion, neither subsidiary meets both criteria of a primary beneficiary on a stand-alone basis.

As Subsidiary A is acting in an agent capacity (i.e., it is not considered a decision maker), the related party group under common control would not meet the criteria in ASC 810-10-25-44A in order to apply the related party tiebreaker test.

Further, unless “substantially all” of the partnership’s activities involve or are conducted on behalf of Subsidiary B, Subsidiary B would also not be required to consolidate the partnership under ASC 810-10-25-44B.

Parent analysis

Reporting Entity X, as a parent, meets both the power criterion (through Subsidiary A) and the losses/benefits criterion (through Subsidiary B), and therefore would be the primary beneficiary of Partnership Y and would consolidate Partnership Y in its consolidated financial statements.

2.4.6.3 Related party groups that are not under common control that meet both characteristics of a primary beneficiary

If a single decision maker within a related party group has unilateral power, and the related party group is not under common control, then the related party tiebreaker would not apply. However, if “substantially all” of the VIE’s activities involve or are conducted on behalf of any party within that related party group that meets both characteristics of a primary beneficiary (excluding the single decision maker), then the party that has the activities conducted on its behalf is required to consolidate the VIE. This requirement is intended to prevent abuse (i.e., “vote parking” arrangements) where the decision maker’s level of economics is not consistent with its stated power.

This assessment, which is intended to be consistent with the analysis required to determine whether an entity is a VIE (refer to CG 2.3), should be qualitative and consider all relevant facts and circumstances.

Example 2-47 illustrates the application of the “substantially all” related party test.
EXAMPLE 2-47

Application of the “substantially all” related party test

Company A, Company B, and Company C formed a venture (Company X) that was determined to be a VIE. Company X’s outstanding equity interests are owned as follows:

- Company A – 5%
- Company B – 45%
- Company C – 50%

Each party participates in Company X’s profits and losses on a pro rata basis.

Company B financed Company A’s investment in Company X, therefore, Company A and Company B were determined to be related parties in accordance with the de facto agency guidance in ASC 810-10-25-43(b).

Company A, through super-voting shares, has the ability to unilaterally direct a majority of Company X’s economically significant activities. Neither Company B nor Company C have substantive participating rights, therefore, Company A meets the power criterion. Company A does not receive a decision-making fee, therefore, the ASC 810-10-55-37 agency test would not be applicable.

Which party should consolidate the VIE?

Analysis

Although Company A has power, it does not meet the losses/benefits criterion since it is not exposed to losses and/or benefits that could potentially be significant to the VIE. Therefore, Company A is not Company X’s stand-alone primary beneficiary. A related party group consisting of Company A (a single decision maker) and Company B (a variable interest holder with a potentially significant economic interest) does exist. Because the related party group is not under common control, the related party tiebreaker test would not be applicable. However, an analysis should be performed to determine whether substantially all of Company X’s activities are conducted on Company B’s behalf. If that were the case, Company B would be Company X’s stand-alone primary beneficiary.

2.4.7 Identifying the primary beneficiary within a related party group—related party tie breaker

ASC 810-10-25-44

The guidance in this paragraph shall be applicable for situations in which the conditions in paragraph 810-10-25-44A have been met or when power is shared for a VIE. In situations in which a reporting entity concludes that neither it nor one of its related parties has the characteristics in paragraph 810-10-25-38A but, as a group, the reporting entity and its related parties (including the de facto agents described in paragraph 810-10-25-43) have those characteristics, then the party within the related party group that is most closely associated with the VIE is the primary beneficiary. The determination of which party within the related party group is most closely associated with the VIE...
Variable interest entity model

requires judgment and shall be based on an analysis of all relevant facts and circumstances, including all of the following:

a. The existence of a principal-agency relationship between parties within the related party group

b. The relationship and significance of the activities of the VIE to the various parties within the related party group

c. A party’s exposure to the variability associated with the anticipated economic performance of the VIE

d. The design of the VIE.

2.4.7.1 When to apply the related party tie-breaker

Related parties and de facto agency relationships can play a critical role in (1) the determination of whether the entity is a VIE, and (2) the determination of the VIE’s primary beneficiary, if one exists.

Generally, the related party tie-breaker would apply when the related party group, rather than a single party within the group, meets the power and losses/benefits criteria (i.e., group would be the primary beneficiary) and one of the following situations applies:

□ Power is shared among the related party group (i.e., no party within the related party group individually meets the power and losses/benefits criteria, but the related party group collectively meets both characteristics of a primary beneficiary).

□ One of the parties in the related party group meets the power criterion on a stand-alone basis but not the losses/benefits criterion. However, the related party group is under common control and collectively meets the losses/benefits criterion.

In situations where the related party tiebreaker is applied, the identification of the party within the related party group that is most closely associated to the VIE is required. This analysis should be based on the facts and circumstances specific to the VIE being assessed for consolidation.

Question 2-13 addresses the application of the related party tie-breaker when one party within a related party group meets both criteria to be the primary beneficiary, but another receives the majority of the economics.

Question 2-13

If one party within a related party group meets both criteria to be the primary beneficiary, but another party within that group receives the majority of the economics, should the related party tie-breaker be applied?

PwC response

No, the related party tie-breaker should not be applied in this scenario. If one party in the related party group meets both the power and benefits/losses criteria, then that party is the primary beneficiary. If a single party with a majority of the economics lacks stated power, the power criterion should be
carefully analyzed to ensure that single party does not have some form of implied power. Refer to CG 2.4.2.11 for further information on implied power.

2.4.7.2 Applying the related party tie-breaker

In circumstances where the related party tiebreaker must be applied, judgment is required. 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 for 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 606, Revenue Recognition—Principal Agent Considerations, 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 606 may indicate that the reporting entity is acting as a principal. The existence of any indicators listed under Net Revenue Reporting in ASC 606 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 be unclear. 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, they may not be acting as agents of one another. Accordingly, it may be appropriate for the reporting entity to 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 within the related party group, as well as the significance of the VIE’s activities to those members. The member of the related party 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 opposite conclusions
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. The focus of this analysis should not be limited to 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, other factors should be considered, for example:

- Whether one party is significantly dependent upon the VIE as a supply/distribution source;
- Whether one party is the lessee of the VIE’s only asset;
- Whether the reporting entity funds research and development of the VIE that is integral to that party’s underlying operations;
- The nature of the VIE’s business activities, and whether they are inherently aligned with one of the parties within the related party group;
- The significance of the VIE’s sales of product (or output) to one of the parties within the related party group;
- Understanding the nature of service contracts, management contracts, or other contracts entered into by the VIE with a related party, and the importance of that related party to the underlying business activities of the VIE;
- Whether any member within the related party group 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 member within the related party group.

When evaluating this indicator, a reporting entity may also look to the indicators provided in CG 2.3.3.2.

Variability associated with anticipated economics

The third indicator for identifying the primary beneficiary within a related party group focuses on exposure to the VIE’s economic performance. When analyzing this indicator, each variable interest holder’s potential to receive additional benefits or absorb additional losses of the VIE based on changes in the entity’s anticipated economic performance should be considered. Note that this analysis takes into account the member’s obligations and rights throughout the life cycle 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 variations of the anticipated economic results of the VIE.

If a decision maker receives a fee arrangement that is at market and commensurate, we do not believe the decision maker’s exposure to the VIE’s expected risks and rewards can be disregarded for purposes of this criterion. Although at market and commensurate fees are excluded in the variable interest and primary beneficiary determinations, we do not believe it would be appropriate to disregard such fees.
when determining which party within a related party group should consolidate a VIE, particularly when considering that the FASB did not amend the related party tiebreaker guidance.

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, each of the four factors should be considered. If a reporting entity is acting on behalf of another reporting entity in a fiduciary capacity (i.e., as an agent), the reporting entities should understand why the arrangement exists and used reasoned judgment to determine which party this characteristic indicates is most closely associated to the VIE.

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 through variability from the VIE’s expected performance is of little importance, and therefore little weight should be placed on this indicator. However, if the relationship is that of two independent variable interest holders investing in a joint venture where one of the companies cannot sell or transfer its interest without the other’s prior approval (i.e., they are related parties through a de facto agency relationship), 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 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 within the related party group. Examples of these types of relationships may include:

- A VIE was established for the securitization of certain assets and the transferor of those assets;
- A VIE was established to own and lease a single asset to a lessee; and
- A VIE was established to provide off-balance sheet financing to the beneficiary of that financing.

Again, this indicator requires the use of professional judgment, and certain structures/transactions will be more obvious than others.

2.4.8 Ongoing reassessment of the primary beneficiary

If an entity is a VIE, ASC 810-10 requires the primary beneficiary analysis to be performed at formation (or when a reporting initially becomes involved with the VIE), and also at each subsequent reporting date. Changes in facts and circumstances occurring since the previous primary beneficiary determination should be considered as part of this ongoing assessment.

In establishing this requirement, the FASB noted that the requirement for reporting entities to continuously reassess whether they are the primary beneficiary of a VIE would provide benefits to the financial statement users that outweigh the anticipated costs to comply with the requirement. For example, if a reporting entity 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. This ongoing assessment is intended to be performed qualitatively.

When a reporting entity identifies a change in the primary beneficiary of a VIE, it should recognize the effects as of the date when the change occurred.

Because the primary beneficiary of a VIE must be reassessed on an ongoing basis, the determination of related parties (and de facto agents) must also be continuously reassessed.

2.5 Initial consolidation

When a reporting entity obtains control of a legal entity, it must determine if the net assets within the legal entity constitute a business. To the extent it is a business, acquisition accounting procedures under ASC 805 would be applied irrespective of whether control is gained under the VIE or voting interest entity model. Therefore, the initial consolidation of a VIE that is a business and not received in a common control transaction is treated as a business combination. See BCG 1 for the definition of a business and BCG 2 for application of the acquisition method when acquiring a business.

If a reporting entity obtained control of a legal entity that is not a business and not a common control transfer, then it is accounted for as an asset acquisition. See PPE 2 for details on the accounting for acquisitions that do not constitute a business.

If a reporting entity obtained control of a legal entity that is not a business but is a VIE, the primary beneficiary should account for the initial consolidation pursuant to the guidance in ASC 810-10-30-4. No goodwill would be recognized if the variable interest entity is not a business.

ASC 810-10-30-4

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

In limited circumstances, a reporting entity that is determined to be the primary beneficiary of a VIE does not have an equity investment in the entity. In these cases, the primary beneficiary must consolidate 100% of the balance sheet and income statement of the VIE and should generally apply consolidation procedures as if it were the parent in a typical parent-subsidiary relationship. These consolidation procedures include applying the acquisition method if the VIE is a business, and reflecting equity interests in the VIE held by other parties as a noncontrolling interest.
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 in accordance with ASC 810-10-30-3.

As an overriding principle, 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 should be recognized because of the transfer, even if the reporting entity was not the primary beneficiary until shortly after the transfer.

2.5.1 *Measuring the financial assets and liabilities of a consolidated collateralized financing entity*

ASC 810-10-15-17D provides an alternative for measuring the financial assets and financial liabilities of a collateralized financing entity that is consolidated by a reporting entity. The ASC Master Glossary provides the following definition of a collateralized financing entity.

**Definition from ASC Master Glossary**

Collateralized Financing Entity: A variable interest entity that holds financial assets, issues beneficial interests in those financial assets, and has no more than nominal equity. The beneficial interests have contractual recourse only to the related assets of the collateralized financing entity and are classified as financial liabilities. A collateralized financing entity may hold nonfinancial assets temporarily as a result of default by the debtor on the underlying debt instruments held as assets by the collateralized financing entity or in an effort to restructure the debt instruments held as assets by the collateralized financing entity. A collateralized financing entity also may hold other financial assets and financial liabilities that are incidental to the operations of the collateralized financing entity and have carrying values that approximate fair value (for example, cash, broker receivables, or broker payables).

When a reporting entity elects the fair value option, financial assets and financial liabilities of the entity must be measured separately at their fair values. As a result, the aggregate fair value of the financial assets may differ from the aggregate fair value of the financial liabilities. The guidance allows the use of the more observable of the fair value of the financial assets or the fair value of the financial liabilities of the collateralized financing entity to measure both. As a result, this alternative would eliminate the measurement difference that may exist when the financial assets and financial liabilities are measured independently at fair value.

If the new measurement alternative is not elected, reporting entities will have to reflect any measurement differences between the collateralized financing entity's financial assets and third party financial liabilities in earnings and attribute those earnings to the controlling equity interest in the consolidated income statement.
Chapter 3:
Voting interest model
3.1 Chapter overview

This chapter describes the voting interest entity consolidation models for corporations and limited partnerships. It also describes the consolidation by contract model. The voting interest entity consolidation models for corporations and limited partnerships are not the same. Therefore, entities that are not clearly corporations or limited partnerships, such as limited liability companies and trusts, should determine whether their governing provisions as described in their governing documents make them more like a corporation or a limited partnership in deciding which model to apply.

The voting interest entity model (referred to as the “VOE” model) requires the reporting entity to have a controlling financial interest in an entity. A controlling financial interest is generally based on the concept that a reporting entity should have the unilateral right to make the significant financial and operating decisions of an entity without regard to probability.

The voting interest entity model applies to all entities that are not variable interest entities (VIEs). That is, the voting interest model applies after an investor considers whether it has a variable interest in a VIE and determines that the investee is not a VIE. If an entity is not a VIE under ASC 810-10-15-14, the following consolidation guidance under ASC 810 should be considered to determine the appropriate consolidation model depending on the type of entity or arrangement:

- Majority-owned subsidiaries (corporations), see CG 3.2 through 3.4
- Limited partnerships (LPs), see CG 3.5
- Entities controlled by contract, see CG 3.6
- Research and development arrangements, see CG 6.3.1

Figure 3-1 summarizes the voting interest consolidation model for corporations, limited partnerships, and similar entities.
3.2 Control by majority of voting interest – corporations and similar type entities

Under the ASC 810-10 VOE consolidation model, a reporting entity must consolidate any entity in which it has a controlling financial interest.

3.2.1 Controlling financial interest (VOE model)

For entities that are not VIEs, the usual condition for a controlling financial interest is ownership of over 50% of the outstanding voting shares. Under the provisions of ASC 810-10-15-10(a), all majority-
owned subsidiaries (i.e., all companies in which a parent has a controlling financial interest through direct or indirect ownership of a majority voting interest) must be consolidated unless control does not rest with the majority owner. See CG 3.2.3 and 3.4 for situations where control may not rest with the majority owner.

In some cases, more than a simple majority voting interest may be needed to have a controlling financial interest. For example, an entity may have agreements or bylaws requiring approval from two-thirds of the outstanding voting interests for major decisions, rather than a simple majority. In this case, only a holder of at least two-thirds of the outstanding voting interest would have a controlling financial interest.

For SEC registrants, Regulation S-X 1-02(g) defines “control” as “…the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting shares, by contract, or otherwise.” While the SEC’s definition of control suggests that control may be achieved with a less than majority ownership of the voting shares, the SEC does not list specific criteria that should be considered in making that assessment. Rather, Regulation S-X 3A-02 emphasizes the need to consider substance over form to establish an appropriate consolidation policy in determining whether a less than majority owned entity should be consolidated.

The provisions of S-X 3A-02 were frequently applied by the SEC staff prior to the introduction of the VIE consolidation model. However, many of the situations previously subject to S-X 3A-02 are now in the scope of the VIE guidance since many of these entities are VIEs. Consequently, S-X 3A-02 is referenced less today, but nonetheless, should be considered in determining an appropriate consolidation policy.

3.2.2 Assessing control through indirect interest (VOE model)

A reporting entity may control another entity through a combination of both direct and indirect ownership interests held through a controlled intermediate entity. In those cases, it is possible for a reporting entity to have an economic interest of less than 50% of another entity, but still have a controlling financial interest in the entity. Conversely, a reporting entity could have an economic interest of more than 50% of another entity, but lack control because it does not hold a majority voting interest.

Example 3-1 and Example 3-2 describe scenarios in which indirect ownership may or may not result in control.

EXAMPLE 3-1

Control with less than 50% economic interest

Company A has a controlling financial interest in Company B through its 60% ownership interest in Company B. Company B, in turn, owns 40% of Company C. Company A also directly owns 20% of Company C.

Company B and Company C are voting interest entities and all ownership interests represent voting interests. A majority voting interest of an entity is assumed to result in a controlling financial interest.
Should Company A consolidate Company C?

**Analysis**

Yes. Even though Company A only has an economic interest of 44% in Company C (i.e., its 20% direct interest, plus its 60% of Company B’s 40% direct interest in Company C), Company A does have a controlling financial interest in Company C. Since Company A controls Company B, and thus can control Company B’s 40% voting interest in Company C, plus it has a direct 20% voting interest in Company C, Company A has a 60% controlling voting interest in Company C.

**EXAMPLE 3-2**

No control with more than 50% economic interest

Company A owns 40% of Company B. Company B, in turn, has a controlling financial interest in Company C through its 60% ownership interest in Company C. Company A also directly owns 30% of Company C.

Company B and Company C are voting interest entities and all ownership interests represent voting interests. A majority voting interest of an entity is assumed to result in a controlling financial interest.

Should Company A consolidate Company C?
Analysis

No. Even though Company A has an economic interest of 54% in Company C (i.e., its 30% direct interest, plus its 40% of Company B’s 60% direct interest in Company C), it does not control Company C. Since Company A does not control Company B, Company A would not be able to combine Company B’s 60% interest in Company C with its 30% direct interest in Company C to obtain a controlling financial interest in Company C.

3.2.3 Exceptions to consolidation by a majority owner (VOE model)

Under ASC 810-10, all majority-owned subsidiaries (i.e., all entities in which a parent has a controlling financial interest through direct or indirect ownership of a majority voting interest) must be consolidated, unless control does not rest with the majority owner.

The following are instances where control does not rest with the majority owner:

- The subsidiary is in legal reorganization or in bankruptcy. Refer to BLG for further discussion.
- The subsidiary operates under foreign exchange restrictions, controls, or other governmentally imposed uncertainties so severe that they cast significant doubt on the parent’s ability to control the subsidiary. Evidence of such a lack of control includes a parent’s inability to repatriate funds of a subsidiary because of long-term exchange restrictions, political uncertainties, threats of expropriation of a subsidiary’s assets, and other similar situations. Refer to CG 4.3.
- The majority owner’s voting rights are restricted by certain approval or veto rights granted to the noncontrolling shareholder, which qualify as substantive participating rights. Refer to CG 3.4.
- The parent is a broker-dealer within the scope of ASC 940, Financial services—brokers and dealers, and has a controlling financial interest in a subsidiary for which control is likely to be temporary. This exception for when control is likely to be temporary should not be analogized to reporting entities that are not broker/dealers. Refer to ASC 940-810-45-1.

3.3 Control without majority of voting stock – corporations and similar entities

In some circumstances, a reporting entity may have a controlling financial interest in another entity (which is not a VIE) without owning a majority voting interest. The accounting for these situations should be determined based on the economic substance of the transaction.

3.3.1 Potential voting rights, including call options and convertible instruments

Entities may issue various financial instruments to reporting entities that provide the reporting entities with potential voting rights. For example, entities may issue call options, convertible instruments, and other similar instruments with potential voting rights to reporting entities. Depending on the terms, these instruments, if exercised or converted, may provide the reporting entity with a controlling financial interest in the entity. In these situations, questions may arise as to whether the reporting entity has a controlling financial interest in the entity prior to exercise or conversion of these financial instruments.
Generally, under the voting interest entity model, these types of financial instruments are not included in the determination of whether the reporting entity has a controlling financial interest in the entity as the voting interest entity model is not an effective control model. However, in certain limited circumstances, the terms and conditions of these instruments may make them so highly likely of exercise or conversion that a reporting entity may be deemed to have a controlling financial interest in the entity even though the instruments have not been actually exercised or converted. In making this assessment, a reporting entity should consider all facts and circumstances, including its relationships with the entity and other investors. Although not all inclusive, the reporting entity should consider the following:

- **Terms of the financial instrument** – is there a high likelihood that the instrument will be exercised or converted? Is the instrument currently exercisable or convertible? Is the exercise or conversion price significantly in the money or a nominal amount? Does the exercise or conversion period span a long period of time? For example, if an option is currently exercisable with a nominal exercise price, the exercise of the option would likely have no significant effect on the investor and, therefore, the investor may have the ability to currently control the entity. On the other hand, an option that is not currently exercisable and at an exercise price that is not substantially in the money would likely indicate that the exercise of the option is substantive and the investor does not have the current ability to control the entity.

- **Relationships with entity and other investors** – is the reporting entity controlling the operational and financial decisions of the entity by virtue of the nature of its relationships with the entity? Is the entity dependent on the reporting entity or vice versa? If so, how critical is that dependency? Does the reporting entity have call or put options with the other investors of the entity?

- **Purpose of the entity** – is the entity being used for research and development activities, start-up activities, or marketing activities? Is the entity expected to incur losses in the early years of operations? If so, is this structure being used to avoid recording losses?

### 3.3.2 Control of the board of directors

A reporting entity may have a controlling financial interest in a less-than-majority-owned entity when the reporting entity has control of the board of directors, and the significant decisions of the entity are made at the board level. For example, a reporting entity may, without owning a majority of the voting shares, have the ability to appoint or elect the majority of the board of directors. These types of situations may be agreed upon and reflected in an entity’s governing documents (articles of incorporation, by-laws, or operating agreements) or by other separate agreements with the shareholders (voting proxies or other contractual arrangements). In making the determination of whether a less-than-majority owner demonstrates a controlling financial interest and should consolidate, the reporting entity should ensure that 1) the significant decisions of the entity are made at the board of directors level, 2) any matters voted upon at the shareholder level are not considered significant decisions, 3) other shareholders or other parties are not able to change the composition of the board of directors, and 4) the ability to appoint a majority of the board of directors is for a substantial period of time.

In addition, the conditions providing a less-than-majority owner with control of the board may require further consideration of whether the entity is a voting interest entity or a VIE. See CG 2.3 for guidance on determining whether an entity is a VIE.
Example 3-3 and Example 3-4 provide additional guidance and factors to consider when assessing whether a less-than-majority-owned entity should be consolidated because of control of the board of directors.

**EXAMPLE 3-3**

Evaluating whether a controlling financial interest exists when one investor has the ability to appoint the majority of the board of directors

Company A and several private equity investors establish Company X. Company A owns 49% of the voting stock of Company X. None of the private equity investors own more than 15% of the voting stock. Through the articles of incorporation of Company X, the board of directors makes all significant financial and operating decisions. Any matters voted on by the shareholders of Company X are considered protective rights. The board of directors will consist of seven directors, four of which will be appointed by Company A as long as Company A owns more than 45% of the voting stock. The significant decisions are made at the board level by simple majority. The articles of incorporation cannot be changed without a supermajority of the vote of Company X’s shareholders. The private equity investors do not have any veto or substantive participating rights (see further discussion in CG 3.4). Assume Company X is not a VIE.

Should Company A consolidate Company X under the voting interest model?

**Analysis**

Yes. Company A should consolidate Company X under the voting interest model because it has the unilateral right to make the significant financial and operating decisions of Company X as a result of having the right to appoint four of the seven directors.

**EXAMPLE 3-4**

Evaluating a controlling financial interest when voting ownership is widely dispersed

Company A owns 49% of the voting stock of Company B, an established profitable entity. The remaining 51% is widely held and the probability that the entire 51% would vote in concert is remote. Company A does not own any convertible securities, options, or warrants in Company B, and there are no other agreements that affect the voting or management structure of Company B. The directors of Company B are elected by the shareholders of Company B at the annual shareholders meeting by simple majority present, subject to a minimum quorum requirement. The significant decisions of Company B are made at the board level by simple majority vote.

Should Company A consolidate Company B?

**Analysis**

No. While it is remote that Company A will not be able to elect all of the directors of Company B (as the other shareholders will most likely not all vote, or if they did, would most likely not all vote in unison), Company A does not have the unilateral right or power to direct the significant operational and financial actions of the investee. This unilateral right is generally applied without regard to probability. Thus, absent any other agreements that affect the voting or management structure,
Company A should not consolidate Company B as it does not have the unilateral right to appoint the majority of the board of directors of Company B.

3.3.3 Control through contractual arrangements

A reporting entity with less than a majority of voting interests can also gain control of an entity through contractual arrangements. For example, a reporting entity may have:

- An agreement with other voting interest holders that they will always vote in concert with the reporting entity, thus allowing the reporting entity to have a majority voting interest

- A minority voting interest, but by virtue of a contract or other arrangement, have the ability to direct the significant decisions and activities of the entity (see also CG 3.6)

The reporting entity should exercise significant care when determining if it has a controlling financial interest in these situations. The reporting entity should perform a careful analysis of the arrangement, including the rights of all the parties (e.g., termination provisions) and the terms of the arrangement. These contractual arrangements may also cause the entity to be a VIE, and therefore subject to the VIE consolidation model. See CG 2.3 for guidance on determining whether an entity is a VIE.

3.4 Noncontrolling shareholder rights

ASC 810-10-25-2 through ASC 810-10-25-14 addresses the issue of whether consolidation is appropriate when one shareholder or partner has a majority voting interest in another entity, but the powers of the majority shareholder or partner to control the operations or assets of the investee are restricted in certain respects by approval or veto rights granted to the noncontrolling interest holder(s). A similar concept applies to limited partnerships. The approval or veto rights granted to the noncontrolling shareholder(s) or limited partner(s) may be considered as either protective or participating rights. The ASC guidance noted above applies to corporations and limited partnerships that are not VIEs. It does not apply to entities that carry substantially all of their assets at fair value.

This section focuses on noncontrolling shareholder rights relating to corporations. Refer to CG 3.5.3 for discussion about limited partner rights relating to limited partnerships.

The assessment of whether noncontrolling shareholder rights should preclude a majority shareholder from consolidating is a matter of judgment that depends on facts and circumstances. The framework in which such facts and circumstances are judged should be based on whether the noncontrolling shareholder rights, individually or in the aggregate, provide for the noncontrolling shareholder to effectively participate in significant decisions that would be expected to be made in the “ordinary course of business.” This assessment should be made at the time a majority voting interest is obtained and should be reassessed if there is a significant modification to the terms of the rights of the noncontrolling shareholder.

Under this framework, the shareholder with the majority voting interest must assess whether the noncontrolling shareholder’s rights are protective rights or substantive participating rights. Protective rights do not overcome the presumption that a majority shareholder exerts control, while substantive participating rights, even though also protective of the investment, would overcome the presumption of control by the majority shareholder.
3.4.1 **Protective rights**

Protective rights held by noncontrolling shareholders do not preclude consolidation. Protective rights are defined as follows under the voting interest model:

**Definition from ASC 810-10**

Protective Rights (Voting Interest Entity Definition): Rights that are only protective in nature and that do not allow the limited partners or noncontrolling shareholders to participate in significant financial and operating decisions of the limited partnership or corporation that are made in the ordinary course of business.

ASC 810-10-25-10 provides a list, not intended to be all-inclusive, of noncontrolling shareholder rights that would be considered protective rights and would not preclude the majority voting interest investor from consolidating the investee:

**ASC 810-10-25-10**

Noncontrolling rights (whether granted by contract or by law) that would allow the noncontrolling shareholder or limited partner to block corporate or partnership actions would be considered protective rights and would not overcome the presumption of consolidation by the investor with a majority voting interest or limited partner with a majority of kick-out rights through voting interests in its investee. The following list is illustrative of the protective rights that often are provided to the noncontrolling shareholder or limited partner but is not all-inclusive:

- a. Amendments to articles of incorporation or partnership agreements of the investee
- b. Pricing on transactions between the owner of a majority voting interest or limited partner with a majority of kick-out rights through voting interests and the investee and related self-dealing transactions
- c. Liquidation of the investee in the context of Topic 852 on reorganizations or a decision to cause the investee to enter bankruptcy or other receivership
- d. Acquisitions and dispositions of assets that are not expected to be undertaken in the ordinary course of business (noncontrolling rights relating to acquisitions and dispositions of assets that are expected to be made in the ordinary course of business are participating rights; determining whether such rights are substantive requires judgment in light of the relevant facts and circumstances (see paragraphs 810-10-25-13 and 810-10-55-1))
- e. Issuance or repurchase of equity interests.
3.4.2 Substantive participating rights

Participating rights are defined as follows under the voting interest model:

**Definition from ASC 810-10**

Participating Rights (Voting Interest Entity Definition): Participating rights allow the limited partners or noncontrolling shareholders to block or participate in certain significant financial and operating decisions of the limited partnership or corporation that are made in the ordinary course of business. Participating rights do not require the holders of such rights to have the ability to initiate actions.

ASC 810-10-25-11 provides a list, not intended to be all-inclusive, of noncontrolling shareholder rights that should be considered participating rights and would overcome the presumption of consolidation by the holder of a majority voting interest:

**ASC 810-10-25-11**

Noncontrolling rights (whether granted by contract or by law) that would allow the noncontrolling shareholder or limited partner to effectively participate in either of the following corporate or partnership actions shall be considered substantive participating rights and would overcome the presumption that the investor with a majority voting interest or limited partner with a majority of kick-out rights through voting interests shall consolidate its investee. The following list is illustrative of substantive participating rights, but is not necessarily all-inclusive:

a. Selecting, terminating, and setting the compensation of management responsible for implementing the investee’s policies and procedures

b. Establishing operating and capital decisions of the investee, including budgets, in the ordinary course of business.

**ASC 810-10-25-12**

The rights noted in paragraph 810-10-25-11 are participating rights because, in the aggregate, the rights allow the noncontrolling shareholder or limited partner to effectively participate in certain significant financial and operating decisions that occur as part of the ordinary course of the investee’s business and are significant factors in directing and carrying out the activities of the business. Individual rights, such as the right to veto the termination of management responsible for implementing the investee’s policies and procedures, should be assessed based on the facts and circumstances to determine if they are substantive participating rights in and of themselves. However, noncontrolling rights that appear to be participating rights but that by themselves are not substantive (see paragraphs 810-10-25-13 and 810-10-55-1) would not overcome the presumption of consolidation by the investor with a majority voting interest or limited partner with a majority of kick-out rights through voting interests in its investee. The likelihood that the veto right will be exercised by the noncontrolling shareholder or limited partner should not be considered when assessing whether a noncontrolling right is a substantive participating right.

A noncontrolling shareholder does not need to participate in all of the rights described in ASC 810-10-25-11(a) and 11(b) to overcome the presumption that the majority owner controls the entity. As indicated in ASC 810-10-25-12, individual rights should be assessed based on the facts and
circumstances to determine if they are substantive participating rights in and of themselves. The ability of a noncontrolling shareholder to approve either the operating or the capital budget could be a substantive participating right and overcome the presumption that the majority owner controls the entity. Furthermore, a noncontrolling shareholder’s right over hiring, firing, or setting the compensation of management could also be a substantive participating right. For example, a right held by a noncontrolling shareholder to veto the setting of compensation of management responsible for implementing the investee’s policies and procedures could itself be considered substantive and overcome the presumption of control by the majority owner when the noncontrolling shareholder can exercise that right without any restrictions or conditions (e.g., no limit on the number of times a noncontrolling shareholder can exercise its right).

For a participating right to be substantive, it does not mean the noncontrolling shareholder must have the ability to initiate actions. Rather, it is only necessary that the noncontrolling shareholder’s approval must be obtained by the majority shareholder in order for the majority shareholder to take certain actions. Further, participating rights may be granted by contract (e.g., as a part of the shareholder arrangement) or by law (e.g., certain countries may require that noncontrolling shareholders interests held by local ownership have certain rights with respect to their ownership interest).

3.4.2.1 Participating rights: VOE vs. VIE definition

Both the voting interest model and the VIE model have their own definitions of a participating right. The definitions, while similar, can result in different applications. The voting interest model focuses on the right to block or participate in the significant financial and operating decisions of the entity made in the ordinary course of business, while the VIE model focuses on the right to block or participate in the decisions that most significantly impact the VIE’s economic performance. In addition, ASC 810-10-25-2 through ASC 810-10-25-14 provides examples on what constitutes a participating right under the voting interest model, however, it does not provide any examples on what constitutes a participating right under the VIE model. Given these circumstances, practice has developed where the two definitions can result in different outcomes. For example, a right to veto the compensation of management would likely be considered a substantive participating right under the voting interest model, while it might not significantly impact the entity’s economic performance.

Participating rights under the voting interest model would preclude consolidation by a majority shareholder or partner whether exercisable by a single investor or a group of investors. However, under the VIE model, only participating rights exercisable by a single investor (including its related parties and de facto agents) would preclude consolidation.

Under the VIE model, the presence or absence of a participating right may determine whether an entity is a VIE and also which reporting entity may be the primary beneficiary. When assessing whether an entity is a VIE and in particular whether the equity holders as a group lack the power to direct the entity’s significant activities, ASC 810-10-15-14(b) clarifies that substantive noncontrolling shareholder participating rights under the voting interest model do not automatically make the entity a VIE as the holders of equity at risk as a group may still have the power to direct the entity’s significant activities.

3.4.3 Evaluating whether participating rights are substantive

Determining whether a participating right is substantive requires judgment. For noncontrolling shareholder rights to be considered substantive, there should be no significant barriers to the exercise
of the rights (i.e., conditions, financial penalties, or other operational hurdles making it difficult or unlikely that they could be exercised). As explained in ASC 810-10-25-12, once it is determined that there are no significant barriers to exercise, the likelihood that the rights will be exercised by the noncontrolling shareholder should not be considered when assessing whether a noncontrolling right is a substantive participating right. Noncontrolling shareholder participating rights that are not substantive would not preclude consolidation by an investor who has a majority voting interest in the entity.

ASC 810-10-25-13 provides several factors to consider when assessing whether a participating right is substantive.

**ASC 810-10-25-13**

The following factors shall be considered in evaluating whether noncontrolling rights that appear to be participating are substantive rights, that is, whether these factors provide for effective participation in certain significant financial and operating decisions that are made in the investee’s ordinary course of business:

a. Consideration shall be given to situations in which a majority shareholder or limited partner with a majority of kick-out rights through voting interests owns such a significant portion of the investee that the noncontrolling shareholder or limited partner has a small economic interest. As the disparity between the ownership interest of majority and noncontrolling shareholders or between the limited partner with a majority of kick-out rights through voting interests and noncontrolling limited partners increases, the rights of the noncontrolling shareholder or limited partner are presumptively more likely to be protective rights and shall raise the level of skepticism about the substance of the right. Similarly, although a majority owner is presumed to control an investee, the level of skepticism about such ability shall increase as the investor’s or limited partner’s economic interest in the investee decreases.

b. The governing documents shall be considered to determine at what level decisions are made—at the shareholder or limited partner level or at the board level—and the rights at each level also shall be considered. In all situations, any matters that can be put to a vote of the shareholders or limited partners shall be considered to determine if other investors, individually or in the aggregate, have substantive participating rights by virtue of their ability to vote on matters submitted to a shareholder or limited partner vote.

c. Relationships between the majority and noncontrolling shareholders or partners (other than an investment in the common investee) that are of a related-party nature, as defined in Topic 850, shall be considered in determining whether the participating rights of the noncontrolling shareholder or limited partner are substantive. For example, if the noncontrolling shareholder or limited partner in an investee is a member of the immediate family of the majority shareholder, general partner, or limited partner with a majority of kick-out rights through voting interests of the investee, then the rights of the noncontrolling shareholder or limited partner likely would not overcome the presumption of consolidation by the investor with a majority voting interest or limited partner with a majority of kick-out rights through voting interests in its investee.

d. Certain noncontrolling rights may deal with operating or capital decisions that are not significant to the ordinary course of business of the investee. Noncontrolling rights related to decisions that are not considered significant for directing and carrying out the activities of the investee’s business are not substantive participating rights and would not overcome the presumption of consolidation.
by the investor with a majority voting interest or limited partner with a majority of kick-out rights through voting interests in its investee. Examples of such noncontrolling rights include all of the following:

1. Location of the investee’s headquarters

2. Name of the investee

3. Selection of auditors

4. Selection of accounting principles for purposes of separate reporting of the investee’s operations.

e. Certain noncontrolling rights may provide for the noncontrolling shareholder or limited partner to participate in certain significant financial and operating decisions that are made in the investee’s ordinary course of business; however, the existence of such noncontrolling rights shall not overcome the presumption that the majority owner shall consolidate, if it is remote that the event or transaction that requires noncontrolling shareholder or limited partner approval will occur. Remote is defined in Topic 450 as the chance of the future event or events occurring being slight.

f. An owner of a majority voting interest or limited partner with a majority of kick-out rights through voting interests who has a contractual right to buy out the interest of the noncontrolling shareholder or limited partner in the investee for fair value or less shall consider the feasibility of exercising that contractual right when determining if the participating rights of the noncontrolling shareholder or limited partner are substantive. If such a buyout is prudent, feasible, and substantially within the control of the majority owner, the contractual right to buy out the noncontrolling owner or limited partner demonstrates that the participating right of the noncontrolling shareholder or limited partner is not a substantive right. The existence of such call options, for purposes of the General Subsections, negates the participating rights of the noncontrolling shareholder or limited partner to veto an action of the majority shareholder or general partner, rather than create an additional ownership interest for that majority shareholder. It would not be prudent, feasible, and substantially within the control of the majority owner to buy out the noncontrolling shareholder or limited partner if, for example, either of the following exists:

1. The noncontrolling shareholder or limited partner controls technology that is critical to the investee.

2. The noncontrolling shareholder or limited partner is the principal source of funding for the investee.

Many factors can influence whether a participating right is substantive. Investors should not only refer to the list above, but also keep in mind that there could be other factors that could influence their assessment. These factors could be different from entity to entity, depending on an entity’s operations.

The two main underlying principles of a substantive participating right is that (1) the right over the decision has to be expected to be made in the ordinary course of business, and (2) it has to be expected to have a significant effect on the financial and operating decisions of the entity. If both of these principles are not present, the right would not be a substantive participating right. The ordinary course of business assessment is based on the specific entity’s business and can be different from business to business and also industry to industry.
### Examples of assessing individual noncontrolling shareholder rights

In addition to the factors above, ASC 810-10-55-1 provides various examples of how to assess individual noncontrolling shareholder rights. These examples should not be considered all-inclusive. Judgment should be applied based on the specific facts and circumstances in each arrangement in order to determine whether the rights of the noncontrolling shareholder should be considered protective or participating, and if participating, whether the rights are substantive.

**ASC 810-10-55-1**

Examples of how to assess individual noncontrolling rights facilitate the understanding of how to assess whether the rights of the noncontrolling shareholder or limited partner should be considered protective or participating and, if participating, whether the rights are substantive. An assessment is relevant for determining whether noncontrolling rights overcome the presumption of control by the majority shareholder or limited partner with a majority of kick-out rights through voting interests in an entity under the General Subsections of this Subtopic. Although the following examples illustrate the assessment of participating rights or protective rights, the evaluation should consider all of the factors identified in paragraph 810-10-25-13 to determine whether the noncontrolling rights, individually or in the aggregate, provide for the holders of those rights to effectively participate in certain significant financial and operating decisions that are made in the ordinary course of business:

a. The rights of the noncontrolling shareholder or limited partner relating to the approval of acquisitions and dispositions of assets that are expected to be undertaken in the ordinary course of business may be substantive participating rights. Rights related only to acquisitions that are not expected to be undertaken in the ordinary course of the investee’s existing business usually are protective and would not overcome the presumption of consolidation by the investor with a majority voting interest or limited partner with a majority of kick-out rights through voting interests in its investee. Whether a right to approve the acquisition or disposition of assets is in the ordinary course of business should be based on an evaluation of the relevant facts and circumstances. In addition, if approval by the shareholder or limited partner is necessary to incur additional indebtedness to finance an acquisition that is not in the investee’s ordinary course of business, then the approval by the noncontrolling shareholder or limited partner would be considered a protective right.

b. Existing facts and circumstances should be considered in assessing whether the rights of the noncontrolling shareholder or limited partner relating to an investee’s incurring additional indebtedness are protective or participating rights. For example, if it is reasonably possible or probable that the investee will need to incur the level of borrowings that requires noncontrolling shareholder or limited partner approval in its ordinary course of business, the rights of the noncontrolling shareholder or limited partner would be viewed as substantive participating rights.

c. The rights of the noncontrolling shareholder or limited partner relating to dividends or other distributions may be protective or participating and should be assessed in light of the available facts and circumstances. For example, rights to block customary or expected dividends or other distributions may be substantive participating rights, while rights to block extraordinary distributions would be protective rights.

d. The rights of the noncontrolling shareholder or limited partner relating to an investee’s specific action (for example, to lease property) in an existing business may be protective or participating and should be assessed in light of the available facts and circumstances. For example, if the
investee had the ability to purchase, rather than lease, the property without requiring approval of the noncontrolling shareholder or limited partner, then the rights of the noncontrolling shareholder or limited partner to block the investee from entering into a lease would not be substantive.

**e.** The rights of the noncontrolling shareholder or limited partner relating to an investee’s negotiation of collective bargaining agreements with unions may be protective or participating and should be assessed in light of the available facts and circumstances. For example, if an investee does not have a collective bargaining agreement with a union or if the union does not represent a substantial portion of the investee’s work force, then the rights of the noncontrolling shareholder or limited partner to approve or veto a new or broader collective bargaining agreement are not substantive.

**f.** Provisions that govern what will occur if the noncontrolling shareholder or limited partner blocks the action of an owner of a majority voting interest or general partner need to be considered to determine whether the right of the noncontrolling shareholder or limited partner to block the action has substance. For example, if the shareholder or partnership agreement provides that if the noncontrolling shareholder or limited partner blocks the approval of an operating budget, then the budget simply defaults to last year’s budget adjusted for inflation, and if the investee is a mature business for which year-to-year operating budgets would not be expected to vary significantly, then the rights of the noncontrolling shareholder or limited partner to block the approval of the operating budget do not allow the noncontrolling shareholder or limited partner to effectively participate and are not substantive.

**g.** Noncontrolling rights relating to the initiation or resolution of a lawsuit may be considered protective or participating depending on the available facts and circumstances. For example, if lawsuits are a part of the entity’s ordinary course of business, as is the case for some patent-holding companies and other entities, then the noncontrolling rights may be considered substantive participating rights.

**h.** A noncontrolling shareholder or limited partner has the right to veto the annual operating budget for the first X years of the relationship. Based on the facts and circumstances, during the first X years of the relationship this right may be a substantive participating right. However, following Year X there is a significant change in the exercisability of the noncontrolling right (for example, the veto right terminates). As of the beginning of the period following Year X, that right would no longer be a substantive participating right and would not overcome the presumption of consolidation by the investor with a majority voting interest or limited partner with a majority of kick-out rights through voting interests in its investee.

When assessing whether noncontrolling shareholder rights are participating or protective, the reporting entity should consider all facts and circumstances, including any contractual provisions, including the examples below, that limit, constrain, or otherwise override the rights of the noncontrolling shareholder.

- The noncontrolling shareholder only has the right to approve the acquisition or disposition of assets over a certain dollar limit. The reporting entity should determine whether that dollar limit causes the right to be non-substantive. For instance, if the entity’s long-term plan projects that the dollar limit would not be exceeded in the ordinary course of business, the noncontrolling shareholder’s veto right may not be considered substantive.
In the event of a disagreement between the reporting entity and the non-controlling shareholder, there is a dispute resolution mechanism in place that ultimately allows the reporting entity to prevail. For example, the noncontrolling shareholder can only veto the appointment of an executive position three times and after the third time, the reporting entity is able to make the appointment solely on its own. In this case, the noncontrolling shareholder’s veto right may not be considered substantive because even though the majority shareholder might have to make four attempts to appoint the executive it desires, four attempts would likely not be considered overly burdensome, and the majority shareholder ultimately has the ability to appoint the executive position.

The provision may not allow the noncontrolling shareholder to effectively participate in the entity’s significant financial and operating decisions. For example, if the reporting entity and the non-controlling shareholder cannot agree on the operating budget, the current year budget defaults to last year’s budget adjusted for inflation or some other factor. If the entity is a mature business for which year-to-year operating budgets are not expected to vary significantly, the noncontrolling shareholder’s veto right may not be considered substantive as the rights do not allow the noncontrolling shareholder to effectively participate in a significant decision. Alternatively, consider an example where a reporting entity and the noncontrolling shareholder cannot agree on the operating budget and the disagreement is resolved and decided by an independent arbitrator. In this case, regardless of the arbitration outcome, the participating right would be considered substantive since the reporting entity would not be able to make the decision regarding the operating budget unilaterally.

### 3.5 Control by majority of the voting interest – LPs and similar legal entities

An LP is an association of one or more general partners with unlimited liability and one or more partners with limited liability. It is usually managed by the general partner or partners who may be subject to limitations, as imposed by the partnership agreement. For LPs and similar legal entities, both the general partner (and its affiliates) and the limited partner(s) must first determine the applicability of the VIE consolidation model, including whether (1) the entity is a VIE or (2) the partners or partnership are eligible for one of the scope exceptions. This determination must be performed before considering any other authoritative literature regarding consolidation of the LP. If the partnership is a VIE and the partners or partnership are not eligible for any of the scope exceptions under the VIE guidance, ASC 810 requires that the primary beneficiary, if any, consolidate the VIE. If the partnership is not a VIE, the partners would apply the voting interest model for partnerships in accordance with ASC 810, as further discussed in this section.

An LP can only be a voting interest entity if the limited partners have kick-out rights (including liquidation rights) and/or substantive participating rights. If the limited partners do not have these rights, the LP is a VIE. Therefore, as illustrated in Figure 3-1, under the voting interest model for LPs, only a limited partner can consolidate an LP. Said differently, if a general partner consolidates an LP, the LP is a VIE.

### 3.5.1 Controlling financial interest (VOE model)

For purposes of assessing a controlling financial interest, one must evaluate whether kick-out rights (including liquidation rights) are held by limited partners, since these rights may be the equivalent of voting interests held by shareholders of a corporation. Therefore, a limited partner with a majority of
kick-out rights through voting interests would usually control and consolidate the LP. However, if there are other limited partners holding substantive participating rights, then those rights would overcome the usual condition of control held by the limited partner with a majority of kick-out rights through voting interests.

**ASC 810-10-15-8A**

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

The guidance states that kick-out rights are exercised “through voting interests,” which refers to the voting interest that a limited partner has in the kick-out right. The voting interest that a limited partner has in the kick-out right is generally equal to its economic interest in the LP. For example, assume an LP has a general partner with a 20% ownership interest and four limited partners each having a 20% ownership interest. The four limited partners each have an equal vote in the kick-out right based on their ownership interest, thus each limited partner would have a 20% “voting interest” in deciding whether to exercise the kick-out right to remove the general partner. The general partner does not have a voting interest in the kick-out right. In this example, a simple majority of the voting interests in the kick-out right held by the limited partners would be 41% of the voting interests in the kick-out right, calculated as 51% of the 80% held by the limited partners. This is further described in Example 3-6, Example 3-7, Example 3-8 and Example 3-9.

### 3.5.2 Substantive kick-out rights and liquidation rights (VOE model)

For LPs and similar legal entities, kick-out rights are defined as:

**Definition from ASC 810-20-20**

Kick-Out Rights (Voting Interest Entity Definition): The rights underlying the limited partner’s or partners’ ability to dissolve (liquidate) the limited partnership or otherwise remove the general partners without cause.

Since an LP would be a VIE if the limited partners do not have kick-out rights or substantive participating rights, the assessment of the kick-out rights and substantive participating rights are generally performed when determining whether the LP is a VIE. If the LP is not a VIE, these same rights are then considered in assessing whether a single limited partner, if any, has a controlling financial interest in the LP. That is, the assessment performed during the VIE determination is carried over to the assessment of whether a single limited partner, if any, has a controlling financial interest in the LP.

By definition, kick-out rights are limited to the rights held by limited partners to remove the general partner(s). As mentioned in ASC 810-10-15-14(b)(1)(ii), in order for an LP to not be a VIE, the kick-out rights must be exercisable by a simple majority or lower threshold of limited partner(s). In determining the simple majority required to kick-out the general partner(s), any kick-out rights held
through voting interests by general partner (regardless of whether they are embedded in the general partner interest or through any limited partner interest held by the general partner), by entities under common control with the general partner, and by others acting on behalf of the general partner should be excluded. Also, in determining the simple majority required to kick-out the general partner, the reporting entity needs to calculate and ensure that all possible combinations that represent a simple majority of the limited partners’ voting interests allow for the limited partners to kick-out or remove the general partner. See Example 3-6, Example 3-7, Example 3-8 and Example 3-9 for illustrations of exercising kick-out rights.

Kick-out rights must be substantive in order for them to be assessed under the VIE model pursuant to ASC 810-10-15-14(b)(1)(ii), as well as under the voting interest model. For kick-out rights to be considered substantive, the partners holding the kick-out rights must have the ability to exercise those rights if they choose to do so; that is, there are no significant barriers to the exercise of the rights. If the general partner or one of its related parties is in a position to block the exercise of the kick-out right, the limited partners will likely not have a substantive kick-out right. Refer to CG 2.3.3.2 for more discussion about evaluating whether kick-out rights (including liquidation rights) are substantive.

Kick-out rights are required to be assessed continuously. This is especially important when limited partners are investing in or divesting from the LP. If the limited partners fail to have a kick-out right that meets the requirements described in ASC 810-10-15-14(b)(1)(ii) and ASC 810-10-25-2 through ASC 810-10-25-14C, the LP would become a VIE. This could lead to a change in any consolidation conclusion.

Rights held by general partners to buy out limited partners are not considered kick-out rights as illustrated in Example 3-5.

**EXAMPLE 3-5**

*Buy/sell right between general partner and limited partner*

Partnership X was formed to acquire a single commercial real estate building and to lease the space to multiple tenants. The sole general partner owns 20% of the LP and the sole limited partner (a party unrelated to the general partner) owns 80% of the LP. The partnership agreement states that either partner has the right to offer to buy the other partner’s interest. The buy/sell provision is as follows:

- Offeror can request that offeree sell its interest to offeror at a price determined by the offeror
- Once an offer is made, offeree must either (1) sell its interest to the offeror, or (2) buy the offeror’s interest at the same price

Once the buy/sell provision is triggered, either the offeror or the offeree would end up owning the partnership assets. The limited partner does not have substantive participating rights over the general partner as described in CG 3.5.3.

Does the buy/sell right qualify as a kick-out right or a liquidation right?

**Analysis**

A buy/sell right is generally not a kick-out right or a liquidation right that enables the limited partner to remove the general partner without cause. If the limited partner initiates the buy/sell right, the
Voting interest model

The general partner would control the ultimate outcome of the transaction. The general partner would have the right to either sell its interest to the limited partner or buy the limited partner's interest. The determination that the general partner has the financial ability to buy out the limited partner's interest requires careful consideration. If the general partner has the financial ability to buy out the limited partner's interest (e.g., the general partner is financially capable of purchasing the limited partner's interest or attracting new limited partners), the buy/sell right would not be considered a kick-out right.

In this case, the LP would be a VIE. The partners would apply the guidance in CG 2.4 to identify the primary beneficiary of the VIE, if any. (See the guidance in ASC 360-20-55-21A for further discussion on the accounting implications of real estate agreements that include a buy-sell clause.)

3.5.2.1 Definition of “without cause” (VOE model)

Kick-out rights must be exercisable “without cause” in order to be a valid kick-out right. ASC 810-10 includes the following definitions:

**Definition from ASC 810-10**

With cause generally restricts the limited partners’ ability to dissolve (liquidate) the limited partnership or remove the general partners in situations that include, but that are not limited to, fraud, illegal acts, gross negligence, and bankruptcy of the general partners.

Without cause means that no reason need be given for the dissolution (liquidation) of the limited partnership or removal of the general partners.

Based on the definition of without cause, a provision would only be a kick-out right if it gives the limited partners the right to remove the general partner for no reason, without regard to probability or any condition. Rights to remove the general partner with cause do not meet the definition of a kick-out right (unless the specified causes lack substance). For example, agreements with provisions that give limited partners the right to liquidate the partnership when there is a change in the LP’s key executives, but the general partner controls the change in executives, would not meet the definition of a kick-out right since it can be exercised only with cause.

3.5.2.2 Kick-out right exercisable by a single limited partner (VOE model)

A single limited partner that has the unilateral ability to kick-out the general partner usually controls the LP, assuming the right is substantive (i.e., no significant barriers exist to exercising the right).

**EXAMPLE 3-6**

Simple majority kick-out rights exercisable by a single limited partner

Ten percent of an LP’s economic interest is owned by the general partner and 90% is owned by three independent limited partners, A, B, and C. Limited partners A, B, and C own an economic interest in the LP of 70%, 10%, and 10%, respectively. The general partner does not have any kick-out rights through voting interest. Each of the three limited partners has kick-out rights through voting interests, which is equal to their respective economic interests. The LP agreement requires a simple majority vote of the kick-out rights through voting interests to remove the general partner. There are no
barriers to exercising the kick-out rights, and the limited partners do not have any substantive participating rights. Assume the LP would not be a VIE under any other criteria (except for kick-out rights and participating rights).

Does limited partner A have a controlling financial interest in the LP?

Analysis

Yes. In this example, a simple majority of the kick-out rights through voting interests held by the limited partners would be 46% of the kick-out rights (51% x 90%). The smallest possible combination of limited partners to reach a simple majority of the kick-out rights would be a vote of limited partner A, which represents 70% of the kick-out rights through voting interests. The limited partners would have the power to direct the significant activities of the LP. Since none of the other VIE criteria are met, the LP would be considered a voting interest entity.

Limited partner A has a controlling financial interest and would consolidate the LP as it can unilaterally exercise its kick-out right through voting interests to remove the general partner and none of the other limited partners have any substantive participating rights.

If a partnership agreement requires a supermajority vote (versus a simple majority vote) by the limited partners (based on their voting interests) to remove the general partner, the kick-out right may still meet the requirements in ASC 810-10-15-14(b)(1)(ii), which would indicate that the limited partners have the power to direct the partnership’s activities. This is illustrated in Example 3-7.

EXAMPLE 3-7

Supermajority kick-out rights exercisable by a single limited partner

Ten percent of an LP’s economic interest is owned by the general partner and 90% is owned by three independent limited partners, A, B, and C. Limited partners A, B, and C own an economic interest in the LP of 70%, 10%, and 10%, respectively. The general partner does not have any kick-out rights through voting interest. Each of the three limited partners has kick-out rights through voting interests, which is equal to their respective economic interests. The LP agreement requires a vote of at least 67% of the kick-out rights held by the limited partners through voting interests to remove the general partner. There are no barriers to exercising the kick-out rights, and the limited partners do not have any substantive participating rights. Assume the LP would not be a VIE under any other criteria (except for kick-out rights and participating rights).

Does limited partner A have a controlling financial interest in the LP?

Analysis

Yes. Since the partnership agreement requires a kick-out right calculation that is different than the kick-out right calculation required under ASC 810-10-15-14(b)(1)(ii), any possible combination of simple majority of kick-out rights under the partnership agreement must also be assessed to ensure that it is compliant with the simple majority kick-out right calculation required under ASC 810-10-15-14(b)(1)(ii). The smallest possible combination of limited partners to reach a simple majority of the kick-out rights held by the limited partners under ASC 810-10-15-14(b)(1)(ii) would be a vote of limited partner A, which represents 70% of the kick-out rights through voting interests. Since limited partner A’s 70% of kick-out rights exceeds the 67% threshold required by the partnership agreement,
the limited partners would have the power to direct the significant activities of the LP. Since none of the other VIE criteria are met, the LP would be considered a voting interest entity.

Limited partner A has a controlling financial interest and would consolidate the LP as it can unilaterally exercise its kick-out right through voting interests to remove the general partner and none of the other limited partners have any substantive participating rights.

### 3.5.2.3 Kick-out right exercisable by the limited partners (VOE model)

Kick-out rights through voting interests also could be exercisable by a vote of a simple majority (or a lower percentage) of limited partners’ voting interests. Such rights would demonstrate that the limited partners have the power to direct the activities of the LP. Therefore, assuming none of the other criteria in paragraph 810-10-15-14 are met for the LP to be considered a VIE, the LP would be considered a voting interest entity. Also, if none of the individual limited partners are able to exercise the kick-out right unilaterally, no partner would have a controlling financial interest in the LP as illustrated in Example 3-8.

**EXAMPLE 3-8**

Kick-out right exercisable by the limited partners

An LP includes one general partner, holding a 10% economic interest, and three independent limited partners who each own a 30% economic interest. The general partner does not have any kick-out rights through voting interests. Each of the three limited partners have kick-out rights through voting interests that are equal to their respective economic interests. The LP agreement requires a simple majority vote of the kick-out rights through voting interests to remove the general partner. There are no barriers to exercising the kick-out rights, and the limited partners do not have any substantive participating rights. Assume the LP would not be a VIE under any other criteria (except for kick-out rights and substantive participating rights).

Do any of the limited partners have a controlling financial interest in the LP?

**Analysis**

No. In this example, a simple majority of the kick-out rights through voting interests held by the limited partners would be 46% of the kick-out rights (51% x 90%). The smallest possible combination of limited partners to reach a simple majority of the kick-out rights would be a vote of two limited partners, which represents 60% of the kick-out rights through voting interests. The limited partners would have the power to direct the significant activities of the LP. Since none of the other VIE criteria are met for the LP to be considered a VIE, the LP would be considered a voting interest entity.

Since no single limited partner has a simple majority of the kick-out rights through voting interests to unilaterally remove the general partner, none of the limited partners (nor the general partner) would consolidate the LP.

Sometimes the general partner may also have a vote in deciding whether it should be removed. Kick-out rights held by the general partner and its related parties should be excluded when assessing whether a simple majority or lower threshold of limited partners can exercise the kick-out right.
Therefore, only the kick-out rights held by the limited partners should be considered in the assessment. Example 3-9 illustrates this assessment.

**EXAMPLE 3-9**

Kick-out rights exercisable by the general partner and the limited partners

An LP includes one general partner, holding a 10% economic interest and a 10% limited partner interest, and three independent limited partners who own 30%, 30%, and 20% of the limited partner interests, respectively. The general partner does not have any kick-out rights through voting interests. The limited partners have kick-out rights through voting interests that are equal to their respective economic interest in the LP. The LP agreement requires a simple majority vote of the kick-out rights through voting interests to remove the general partner. There are no barriers to exercising the kick-out rights, and the limited partners do not have any substantive participating rights. Assume the LP would not be a VIE under any other criteria (except for kick-out rights and substantive participating rights).

Do any of the limited partners have a controlling financial interest in the LP?

**Analysis**

No. In this example, the kick-out rights held by the general partner through its LP interest would be disregarded for purposes of determining the simple majority test as required by ASC 810-10-15-14(b)(1)(ii). A simple majority of the kick-out rights through voting interests held by the three independent limited partners would be 41% of the kick-out rights (51% x 80%). The LP agreement requires a simple majority vote of all kick-out rights through voting interests, or 46% of the kick-out rights (51% x 90%).

Since the partnership agreement requires a kick-out right calculation that is different than the kick-out right calculation required under ASC 810-10-15-14(b)(1)(ii), any possible combination of simple majority of kick-out rights under the partnership agreement must also be assessed to ensure that it is compliant with the simple majority kick-out right calculation required under ASC 810-10-15-14(b)(1)(ii). The smallest possible combination of limited partners to reach a simple majority of the kick-out rights held by the limited partners under ASC 810-10-15-14(b)(1)(ii) would be a vote of the two limited partners holding 30% and 20% of the limited partner interest, which represents 63% of the kick-out rights held by the independent limited partners (50%/80%). This combination would also satisfy the simple majority of kick-out rights required under the partnership agreement, which represents 56% of all kick-out rights through voting interests (50%/90%). Therefore, the limited partners would have the power to direct the significant activities of the LP. Since none of the other VIE criteria are met, the LP would be considered a voting interest entity. On the other hand, if the smallest possible combination of limited partners required to kick-out the general partner under ASC 810-10-15-14(b)(1)(ii) did not also satisfy the simple majority kick-out right calculation requirement under the partnership agreement, the LP would be a VIE if the limited partners did not have substantive participating rights.

Since no single limited partner has the unilateral right through voting interests to remove the general partner, none of the limited partners (or the general partner) would consolidate the LP.
3.5.2.4  **Liquidation rights (VOE model)**

As described in ASC 810-10, liquidation rights are included in the definition of kick-out rights. Therefore, the guidance for kick-out rights should be applied in the same manner for liquidation rights (e.g., simple majority concept and no barriers to exercise). However, barriers to exercise for liquidation rights may be different from barriers to exercise for kick-out rights and should be evaluated when assessing whether the rights are substantive. For example, a liquidation right may only allow the limited partners to receive cash upon liquidation as opposed to the assets under management, and thus the limited partners may be less likely to exercise their liquidation rights. However, the mere fact that the limited partners would not receive the assets under management is not by itself a barrier to exercise. All facts and circumstances should be considered in making this assessment, including, for example, why liquidation rights were granted to the limited partners instead of kick-out rights. For example, limited partners of an LP that invest in relatively liquid investments may not have kick-out rights over the general partner because those limited partners have liquidation rights that, if exercised, have the same effect on the general partner as a kick-out right. That is, if the limited partners sought to remove the general partner, they collectively could exercise their liquidation rights. The partnership would terminate, and a new partnership could be formed to make similar liquid investments with a new general partner.

3.5.2.5  **Redemption rights (VOE model)**

As an alternative to providing limited partners with liquidation rights, a partnership agreement may provide the limited partners the right to redeem their interest in whole or in part and, therefore, withdraw from the partnership. However, redemption rights are generally not the equivalent of liquidation rights or kick-out rights. Since redemption rights normally do not result in the complete dissolution of the LP (i.e., exercise of those rights only require that the partnership repurchase the requesting limited partner’s interest), the partnership’s activities continue after redemption. Accordingly, redemption rights generally would not be considered in the consolidation analysis, unless the redemption effectively requires liquidation of the partnership.

**ASC 810-10-25-14B**

The partners’ unilateral right to withdraw from the partnership in whole or in part (withdrawal right) that does not require dissolution or liquidation of the entire limited partnership would not be deemed a kick-out right. The requirement to dissolve or liquidate the entire limited partnership upon the withdrawal of a limited partner or partners shall not be required to be contractual for a withdrawal right to be considered as a potential kick-out right.

Normally, it will be difficult to ascertain that redemption rights held by the limited partner(s) could result in an effective liquidation of the partnership. There must be credible evidence that the right is effectively similar to a liquidation right and that there are no barriers to exercising that right.

However, there may be certain limited circumstances in which the right to redeem the partnership interest results in the liquidation of the partnership. In certain cases, if partnership redemptions reach a certain threshold, the automatic liquidation of the partnership may be triggered. In other cases, a limited partner’s right to have its interest redeemed might compel the general partner to liquidate the partnership in order to finance the redemption. Each case should be assessed based on the facts and circumstances in determining whether a redemption right rises to the level of a liquidation right.
3.5.3 Substantive participating rights (VOE model)

Participating rights are defined as follows under the voting interest model:

Definition from ASC 810-10

Participating Rights (Voting Interest Entity Definition): Participating rights allow the limited partners or noncontrolling shareholders to block or participate in certain significant financial and operating decisions of the limited partnership or corporation that are made in the ordinary course of business. Participating rights do not require the holders of such rights to have the ability to initiate actions.

Excerpt from 810-10-25-14C

Rights of the limited partners to participate in the termination of management (for example, management is outsourced to a party other than the general partner) or the individual members of management of the limited partnership may be substantive participating rights.

As indicated in CG 3.5.2, the assessment of substantive participating rights for LPs is generally performed during the VIE assessment of the LP. This is because if limited partners of an LP do not have either substantive participating rights or kick-out rights, the LP would be a VIE. However, there can be a few exceptions to this assessment sequence. For example, if it is determined that a single limited partner has a kick-out right, any rights that the other limited partners may have might not be assessed during the VIE assessment of the LP. Assuming the LP is not a VIE, any rights that the other limited partners have will have to be assessed during the voting interest assessment in determining whether the single limited partner has a controlling financial interest in the LP.

Some partnership agreements may allow limited partners to participate in decisions that could have a significant impact on the partnership’s business (i.e., significant financial and operating decisions), thereby limiting the rights of the general partner or a limited partner with majority kick-out rights through voting interests. As previously described, if limited partners are able to exercise substantive participating rights over the general partner based on their voting interests, the LP would not be considered a VIE based on the guidance in ASC 810. Assuming none of the other VIE criteria are met, the LP would be considered a voting interest entity. Under the voting interest model, similar to noncontrolling shareholder participating rights in corporations, if limited partners have substantive participating rights, neither the general partner nor the limited partner with a majority of kick-out rights through voting interests would control the LP.

The assessment of whether a limited partner’s participating rights are substantive follows the same guidance in ASC 810-10-25-11 through ASC 810-10-25-13 for the assessment of noncontrolling shareholder participating rights in corporations. A limited partner’s veto right to block actions that are not made in the “ordinary course of business” are protective rights. Refer to CG 3.4 for more discussion about distinguishing participating rights versus protective rights, and evaluating whether participating rights are substantive.

The guidance does not require that a substantive participating right be exercised by at least a simple majority or less of the limited partners (as a kick-out right requires). However, if the percentage of limited partners required to exercise a substantive participating right is very high, this should be considered as a potential barrier to exercise of the right.
3.5.4 **Limited liability companies and other similar legal entities**

The consolidation guidance for LPs also applies to other similar legal entities. A similar legal entity is an entity that has governing provisions and economic characteristics that are the functional equivalent of an LP, and could include entities such as limited liability companies, limited liability partnerships, and others. Therefore, a reporting entity with an interest in a similar legal entity would need to first determine whether the governing provisions of the entity are the functional equivalent of an LP. For example, limited liability companies (LLCs) can have governing provisions that are the functional equivalent of either an LP or a corporation. As a result, a reporting entity with an interest in an LLC will need to determine whether the LLC has governing provisions that are the functional equivalent of an LP or a corporation in order to determine whether it has a controlling financial interest in the LLC. A detailed analysis of the LLC’s formation and governing documents should be performed to understand the LLC’s governance structure and determine whether it is the functional equivalent of an LP or a corporation.

ASC 810-10-05-3 states that for LLCs with managing and non-managing members, a managing member is the functional equivalent of a general partner and a non-managing member is the functional equivalent of a limited partner. In this case, a reporting entity with an interest in an LLC (which is not a VIE) would likely apply the consolidation model for LPs if the managing member has the right to make the significant operating and financial decisions of the LLC. Alternatively, some LLCs are governed by a board of members which makes all the significant operating and financial decisions. In this case, we believe a reporting entity with an interest in an LLC (which is not a VIE) would follow the consolidation model for majority owned subsidiaries (corporations). In other cases, an LLC has both a managing member and a board of members. A reporting entity would need to assess the rights of both the managing member and board of members to determine who is responsible for making the significant operating and financial decisions of the LLC. In practice we have seen cases including the following:

- The managing member is responsible for making the significant operating and financial decisions while the board of members is responsible for activities that would be deemed protective rights, or
- The significant operating and financial decisions are shared between the managing member and the board of members, or
- The managing member is responsible for day-to-day operations while the board of members is responsible for significant operating and financial decisions of the LLC.

As described above, the reporting entity would need to perform a careful analysis to determine whether the governance of the LLC is the functional equivalent of an LP or a corporation.

The guidance in ASC 323-30-35-3 (dealing with specific ownership accounts for each investor) addresses whether an LLC should be viewed as similar to a corporation or similar to a partnership for purposes of determining whether a noncontrolling investment in an LLC should be accounted for at fair value (or using the measurement alternative) or by using the equity method. While this guidance can be used to help assess whether an entity’s governance provisions are the functional equivalent of a corporation or partnership for purposes of assessing whether an investor has a controlling financial interest in an LLC, it should not be the only factor in making that assessment. Refer to CG 4 for further discussion about the equity method of accounting.
### 3.6 Consolidation of entities controlled by contract

ASC 810-10-25 describes the framework for determining when a controlling financial interest has been established through a contractual management arrangement, thus requiring consolidation by the controlling entity.

While this issue was raised specifically to address contractual arrangements between entities that are in business to practice and dispense medicine (physician practices) and entities that are in business to manage the operations of those physician practices (physician practice management entities, or PPMs), it also applies to similar arrangements in other industries.

This guidance only applies to an entity that is not a VIE. Since an entity that is controlled by contract is almost always a VIE (as the equity holders at risk lack the decision making ability), we believe the application of this guidance may be very limited. Therefore, the entity would likely be subject to the VIE model and not the consolidation by contract guidance.

The following requirements must be met for a PPM (reporting entity) to have a controlling financial interest in a physician practice:

- **Term** – the term of the contractual arrangement between the PPM and the physician practice is at least 10 years or for the entire remaining legal life of the physician practice, and the arrangement is not terminable except in the cases of gross negligence, fraud, or other illegal acts by the PPM, or bankruptcy of the PPM. The term must be determined based on its substance rather than its form, and thus, both the original term and renewal or cancellation provisions must be considered. As indicated, the reasons for termination are intended to be very specific and narrow in scope.

- **Control** – the PPM has unilateral decision making over (1) ongoing, major, or central operations of the physician practice, except for the dispensing of medical services, and (2) compensation for the licensed medical professionals as well as the ability to establish and implement guidelines for the selection, hiring, and firing of them. Decision making over ongoing, major, or central operations of the physician practice must include authority over scope of services, patient acceptance policies and procedures, pricing of services, negotiation and execution of contracts, and the establishment and approval of operating and capital budgets. It also includes issuance of debt if debt financing is an ongoing or major source of financing for the physician practice. These significant decisions reflect the minimum level of decision making needed for the PPM to meet the control requirement. The dispensing of medical services is excluded from the PPM’s control only because state law requires licensed medical professionals to dispense medical services and a PPM would generally not satisfy that requirement.

- **Financial interest** – the PPM has a significant financial interest in the physician practice that both (1) is unilaterally saleable or transferable by the PPM and (2) provides the PPM with the right to receive income, both as ongoing fees and as proceeds from the sale of its interest in the physician practice, in an amount that varies based on the operating performance and fair value of the physician practice. If the PPM’s financial interest in the physician practice does not meet both of these criteria, the PPM would not be deemed to have a financial interest in the physician practice.
3.6.1 Nominee shareholder

The consolidation by contract model also introduces the concept of a nominee shareholder(s) into the consolidation model. A nominee shareholder may or may not be used in the PPM/physician practice structure to achieve consolidation. If used, the nominee shareholder is generally the 100% equity shareholder of either a new or the existing physician practice. Simultaneously, the nominee shareholder and the PPM enter into a management agreement that gives control of the physician practice to the PPM. Effectively, the nominee shareholder is an agent of the PPM. The nominee shareholder’s relationship with the PPM perpetually has all the following characteristics:

□ Time frame – the PPM can change or replace the nominee shareholder at any time and as many times as it so chooses.

□ Discretion – the PPM has the sole discretion to establish or change the nominee shareholder and can name anyone it so chooses as the new nominee shareholder.

□ Impact – the PPM and the nominally owned entity incur no more than nominal cost to change the nominee shareholder and there is no significant adverse impact to the physician practice upon a change.

The concept of a nominee shareholder is also very common in many VIE arrangements, including foreign ownership structures, local management agreements, etc.
Chapter 4: 
*Equity method of accounting*
4.1 **Chapter overview**

The equity method of accounting prescribes an approach for a reporting entity (an investor) to measure investments in common stock or other eligible investments by recognizing its share of the economic resources underlying those investments. The equity method applies when an investor does not control an investee, but instead is able to exert significant influence over the operating and financial policies of an investee.

An investor must first determine if it has control over the investee. An investor that directly or indirectly holds a controlling financial interest in another entity is required to consolidate that entity pursuant to either the variable interest entity (“VIE”) or voting interest entity consolidation model, as prescribed by ASC 810. The determination of whether an investor holds a direct or indirect controlling financial interest may require extensive analysis. See CG 2 and CG 3 for further information regarding the application of the consolidation models.

Once an investor has determined that it does not have a controlling financial interest in an investee, it should determine if the equity method of accounting prescribed by ASC 323, *Investments – Equity Method and Joint Ventures* applies. An investor that holds an individual financial interest, or a combination of voting and nonvoting financial interests that includes an investment in common stock or in-substance common stock, and is able to exercise significant influence over the operating and financial policies of the investee would generally account for that investment using the equity method.

An investor should initially record the acquisition of its investment in common stock of an investee and other investments that have risk and reward characteristics that are substantially similar to common stock at cost. When an investor receives an equity method investment as consideration for loss of control of a nonfinancial asset or business, or for transfer of an equity method investment, it should record its investment at fair value. Subsequently, at each reporting period, the investor should adjust the carrying value of its investment to reflect, among other items, its proportionate share of the investee’s income (debit to investment account) or loss (credit to investment account), with a corresponding credit or debit, respectively, to equity in earnings (income statement).

An investor that has the ability to exercise significant influence over the operating or financial policies of the investee has a degree of responsibility for the return on its investment. As such, the equity method of accounting model more closely reflects the investor’s return on its investment, as the investor generally recognizes its proportionate share of the earnings and losses of the investee in the periods in which they are reflected in the accounts of the investee.

Certain exclusions to applying the equity method of accounting exist, such as when an investor has elected to measure an investment at fair value or is applying the proportionate consolidation method allowed in limited circumstances in certain industries. See CG 4.2 for further information regarding these exclusions.

An investment that, individually or in combination with other financial and nonfinancial interests, does not provide the investor with the ability to exercise significant influence should be accounted for under other accounting guidance (e.g., ASC 320, *Investments – Debt Securities* or ASC 321, *Investments – Equity Securities*). This chapter focuses on the application of the equity method to eligible investments.
4.1.1 **Framework to determine investments qualifying for the equity method**

The framework below illustrates the general decision tree in determining whether an investment should be accounted for under the equity method of accounting. This framework should be read in conjunction with the referenced sections, which contain important information to consider when making the determination of whether an investment should be accounted for under the equity method of accounting.

**Figure 4-1**
General framework to determine those investments that should be accounted for under the equity method of accounting

```
| Does the investor hold a controlling financial interest in the investee? |
|-----------------------------|---------------------------------|
| No                          | Yes                             |
| Is the investment scoped out of the equity method of accounting pursuant to ASC 323-10-15-4 and ASC 323-30-15-4? |
| No                          | Yes                             |
| Is the investment an investment in: |
| (a) common stock of a corporation (CG 4.2.1) |
| (b) in-substance common stock of a corporation (CG 4.2.2) |
| (c) a partnership, unincorporated joint venture, or limited liability company (CG 4.2.3)? |
| Yes                         | No                              |
| Does the investor's interest(s) in the investee provide it with the ability to exercise significant influence over the operating and financial policies of the investee (CG 4.3)? |
| No                          | Yes                             |
| Did the investor elect the fair value option for its equity method investment (CG 4.2.5)? |
| No                          | Yes                             |
| Account for the investment pursuant to the equity method of accounting (CG 4.4 and 4.5). |
| Yes                         | No                              |
| Investor should account for all interests in the investee that are eligible for the fair value option at fair value at each reporting period, with changes in value reported in the income statement (CG 4.2.5). |
| No                          | Yes                             |
| Consolidate under the variable interest entity (CG 2) or voting interest entity (CG 3) consolidation models. |
| Refer to CG 4.2.4.          |
```
4.2 **Scope of the equity method**

Investments within the scope of the equity method of accounting include investments in (1) common stock and/or (2) in-substance common stock that individually, or in combination with other financial and nonfinancial interests, do not result in a controlling financial interest, but do result in the ability to exercise significant influence. In addition, certain investments in noncorporate entities, such as partnerships, unincorporated joint ventures, and limited liability companies, are within the scope of the equity method. See CG 4.2.3 for further discussion of these investments and CG 4.3 for further discussion of the concept of significant influence.

4.2.1 **Investments in common stock (equity method)**

Common stock is stock that is subordinate to all other equity of the issuer and is often referred to as common shares. A share of common stock usually provides its holder with voting rights, which enables it to influence the operating and financial policies of an investee. Common stock represents the residual value of an entity after all senior claims (e.g., liabilities, senior classes of equity) have been extinguished.

4.2.2 **In-substance common stock investments (equity method)**

An issuer may issue stock or other instruments that have risk and reward characteristics that are substantially similar to common stock. These instruments are commonly referred to as in-substance common stock investments.

**Definition from ASC 323-10-20**

In-Substance Common Stock: An investment in an entity that has risk and reward characteristics that are substantially similar to that entity’s common stock.

To determine whether an investment is “substantially similar” to the investee’s common stock, an investor should perform a qualitative analysis to determine whether any of the following characteristics exist:

- **Subordination** – An investment with a substantive liquidation preference over the investee’s common stock is not substantially similar to that entity’s common stock. In contrast, an investment with no liquidation preference or a nonsubstantive liquidation preference over that entity’s common stock is an indicator that it may be substantially similar to that investee’s common stock.

When evaluating whether or not differences in the subordination of an investment and that investee’s common stock is substantive, an investor should consider the following:

- The significance of the stated liquidation preference in relation to the purchase price of the investment. The liquidation preference may be substantive if the stated liquidation preference is significant in relation to the purchase price.

- The significance of the fair value of the subordinated equity (common stock) of the investee. A liquidation preference in an investment is more likely to be substantive when the fair value of the investee’s common stock is significant. When there is little or no fair value associated with
the investee’s common stock, it is more likely nonsubstantive because, in the event of liquidation, the investment would participate in substantially all of the investee’s losses.

- Risks and rewards of ownership – An investment is not substantially similar to common stock if it is not expected to participate in the earnings (and losses) and capital appreciation (and depreciation) in a manner that is substantially similar to common stock.

For example, if an investment participates in an investee’s payment of dividends in a manner that is substantially similar to that investee’s common stock, it is an indicator that the investment is substantially similar to common stock. When an investment receives dividends that are not also paid to holders of common stock, it is an indicator that the investment is not substantially similar to common stock.

The ability to convert an investment into that investee’s common stock without any significant restrictions or contingencies that prohibit the investor from participating in the capital appreciation of the investee in a manner that is substantially similar to that investee’s common stock may indicate that the investment is substantially similar to common stock. In making a determination, an investor would also consider the risks inherent in the investment. When significant restrictions or contingencies exist regarding conversion, it likely indicates that the investment is not substantially similar to common stock.

- Obligation to transfer value – An investment is not substantially similar to common stock if the investee is expected to transfer substantive value to the investor that is not also available to common shareholders. For example, an investment that includes a fixed price mandatory redemption provision that is considered significant, but not also available to common shareholders, is an indicator that the investment is not substantially similar to common stock.

An investor should carefully evaluate whether the value to be transferred is substantive. For example, preferred stock with a mandatory redemption in 100 years is not considered a substantive obligation to transfer value through the redemption feature, given the extreme long-dated nature of the specified future date.

If any one of the three aforementioned characteristics exists, the investment is not considered in-substance common stock. In this instance, the investment, in and of itself, would not be within the scope of ASC 323 and the equity method of accounting would not be appropriate, even if significant influence exists.

When an investor cannot determine whether the investment is substantially similar to common stock based upon the qualitative consideration of the three aforementioned characteristics, the investor should quantitatively analyze whether the future changes in the fair value of the investment are expected to vary directly with the changes in the fair value of the investee’s common stock. If not, the investment is not in-substance common stock.

4.2.2.1 Initial determination and reconsideration events (equity method)

The initial determination of whether an investment is substantially similar to common stock is made when an investor determines that it has the ability to exercise significant influence over the operating and financial policies of an investee. In making the determination, an investor should use the information that exists on the date that the investor obtains the ability to exercise significant influence.
The date on which an investor obtains the ability to exercise significant influence may be subsequent to the date that the investment was originally acquired.

For example, subsequent to its initial acquisition of an investment in an investee, an investor may obtain representation on the board of directors that gives it the ability to exercise significant influence over the investee’s operating and financial policies. The investor would perform an initial determination as to whether its investment is in-substance common stock on the date that it obtained board representation.

In certain circumstances, it may be appropriate for an investor to consider interests in an investee that are not yet issued, but are authorized to be issued, in its evaluation of whether an investment is substantially similar to common stock.

Pursuant to the guidance in ASC 323-10-15-16, an investor should reconsider its initial determination if any of the following occur:

□ The contractual terms of the investment are amended, resulting in a change in one or all of the three characteristics described in CG 4.2.2. For example, a change in the form of the investment, such as an exchange of preferred stock for another series of stock, is generally considered a reconsideration event. See FG 3 for guidance on the accounting for modifications of outstanding debt or equity securities. Changes provided for in the original terms of the contractual agreement would generally be considered in the initial determination and not as a reconsideration event.

□ There is a significant change in the capital structure of the investee, including the investee’s receipt of additional subordinated financing. For example, an increase in the number and value of outstanding common stock could affect an investor’s evaluation of whether the subordination characteristics of an investment are substantially different from that of an investee’s common stock.

□ The investor obtains an additional interest in an investee in which the investor has an existing interest. When reconsidering the characteristics of the investment, an investor should consider all interests (the new and the existing) in the investee.

The determination of whether an investment is similar to common stock should not be reconsidered solely due to losses of the investee, even if those losses reduce or eliminate the investee’s common stock to the point where the investee’s common stock has little or no fair value. Rather, an investor should only reconsider whether its investment is substantially similar to common stock when one of the identified reconsideration events or conditions occur.

4.2.2.2  **Put or call option representing in-substance common stock (equity method)**

An investor may obtain an instrument, such as a put or call option, that provides it with the right to purchase or sell the voting common stock of an investee at a future point in time. The investor must determine whether these instruments represent in-substance common stock. In performing this evaluation, an investor should first determine whether the instrument is a freestanding instrument or an embedded feature within a host agreement that might require bifurcation and separate accounting.

If the instrument is freestanding, the investor should determine whether it should be accounted for pursuant to ASC 815, *Derivatives and Hedging*. If the instrument is an embedded feature within a
host agreement, the investor should evaluate whether the instrument should be bifurcated and accounted for separate from the host agreement pursuant to ASC 815. See DH 4 for more information.

The equity method of accounting does not apply to investments accounted for in accordance with ASC 815 (See CG 4.2.4.1). Therefore, the investor should only evaluate those instruments that are not within the scope of ASC 815 to determine whether they represent in-substance common stock of the investee.

Put options, call options, and other instruments that are not accounted for pursuant to ASC 815 may meet the characteristics of in-substance common stock.

4.2.2.3 In-substance common stock determination examples (equity method)

Example 4-1 through Example 4-7 illustrate the evaluation of whether or not an investment is in-substance common stock.

**EXAMPLE 4-1**

Subordination is substantially similar to common stock due to Investee’s common stock having little fair value

On January 1, 20X0, Investor purchased 200,000 shares of preferred stock of Investee in exchange for $20,000,000 ($100 par value, liquidation preference of $100 per share). On January 1, 20X0, the fair value of Investee’s outstanding common stock was $300,000.

Investor has the ability to exercise significant influence over Investee’s operating and financial policies through its investment in Investee.

Are the subordination characteristics of Investor’s investment in the preferred stock of Investee substantially similar to the subordination characteristics of Investee’s common stock?

**Analysis**

The liquidation preference stated in the preferred stock of Investee is equal to the purchase price (and fair value) of the preferred stock on the date of purchase and, therefore, the stated liquidation preference is significant in relation to the purchase price of the investment. However, the fair value of Investee’s common stock ($300,000), compared to the fair value of Investee’s preferred stock ($20,000,000), indicates that Investee has little value associated with its common stock from a fair value perspective. In the event of liquidation, Investor’s investment in the preferred stock of Investee would most likely participate in substantially all of Investee’s losses. As a result, Investor is likely to conclude that the liquidation preference in its investment in the preferred stock of Investee is not substantive and that the subordination characteristics of its investment in the preferred stock of Investee are substantially similar to the subordination characteristics of Investee’s common stock.

Investor should also evaluate the *risks and rewards of ownership* and *obligation to transfer value* criteria in its determination of whether or not its investment in the preferred stock of Investee is in-substance common stock.
EXAMPLE 4-2

Subordination is substantially similar to common stock due to liquidation preference being insignificant in relation to the purchase price of the investment

On January 1, 20X0, Investor purchased 200,000 shares of preferred stock of Investee in exchange for $20,000,000 ($100 par value, liquidation preference of $1 per share). On January 1, 20X0, the fair value of Investee’s outstanding common stock was $100,000,000.

Investor has the ability to exercise significant influence over Investee’s operating and financial policies through its investment in Investee.

Are the subordination characteristics of Investor’s investment in the preferred stock of Investee substantially similar to the subordination characteristics of Investee’s common stock?

Analysis

The liquidation preference stated in the preferred stock of Investee is equal to 1% ($1 per share divided by $100 per share) of the purchase price (and fair value) of the preferred stock on the date of purchase, which appears to be nonsubstantive because the stated liquidation preference is insignificant in relation to the purchase price of the investment.

The fair value of Investee’s common stock ($100,000,000), as compared to the fair value of Investee’s preferred stock ($20,000,000), indicates that Investee has significant value associated with its common stock from a fair value perspective.

Given that the liquidation preference is only 1% of the purchase price, Investor is likely to conclude that the liquidation preference in its investment in the preferred stock of Investee is not substantive and that the subordination characteristics of its investment in the preferred stock of Investee are substantially similar to the subordination characteristics of Investee’s common stock.

Investor should also evaluate the risks and rewards of ownership and obligation to transfer value criteria in its determination of whether or not its investment in the preferred stock of Investee is in-substance common stock.

EXAMPLE 4-3

Subordination is not substantially similar to common stock

On January 1, 20X0, Investor purchased 200,000 shares of preferred stock of Investee in exchange for $20,000,000 ($100 par value, liquidation preference of $100 per share). On January 1, 20X0, the fair value of Investee’s outstanding common stock was $100,000,000.

Investor has the ability to exercise significant influence over Investee’s operating and financial policies through its investment in Investee.

Are the subordination characteristics of Investor’s investment in the preferred stock of Investee substantially similar to the subordination characteristics of Investee’s common stock?
Analysis

The liquidation preference stated in the preferred stock of Investee is equal to the purchase price (and fair value) of the preferred stock on the date of purchase and, consequently, the stated liquidation preference is significant in relation to the purchase price of the investment. Further, the fair value of Investee’s common stock ($100,000,000), as compared to the fair value of Investee’s preferred stock ($20,000,000), indicates that Investee has significant value associated with its common stock from a fair value perspective. Therefore, in the event of liquidation, Investor’s investment in the preferred stock of Investee would likely be protected through the existence of Investee’s common stock, which would most likely absorb a substantial portion of the losses of Investee. As a result, Investor might conclude that the liquidation preference in its investment in the preferred stock of Investee is substantive and that the subordination characteristics of its investment in the preferred stock of Investee are not substantially similar to the subordination characteristics of Investee’s common stock. If so, the preferred stock would not be considered in-substance common stock.

Investor would not be required to evaluate the risks and rewards of ownership and obligation to transfer value criteria when the subordination criterion is not met.

EXAMPLE 4-4

Investment expected to participate in risks and rewards of ownership

On January 1, 20X0, Investor purchased a warrant for $1,000,000. The warrant enables Investor to acquire 50,000 shares of Investee’s common stock at an exercise price of $1.50 per share (total exercise price of $75,000). The warrant is exercisable at any time on or before December 31, 20X0. There are no significant restrictions or contingencies associated with Investor’s ability to exercise the warrant. The warrant does not participate in dividends paid to common shareholders of Investee. However, Investor does not expect Investee to pay dividends to its common shareholders during the exercise period (January 1, 20X0 – December 31, 20X0). On January 1, 20X0, the fair value of Investee’s common stock is approximately $21.00.

Investor has the ability to exercise significant influence over Investee’s operating and financial policies through its investment in Investee.

Is Investor’s investment expected to participate in Investee’s earnings (and losses) and capital appreciation (and depreciation) in a manner that is substantially similar to Investee’s common stock?

Analysis

Investor can exercise the warrant and convert its investment to common stock at any time during the exercise period, without any significant restrictions or contingencies; therefore, Investor’s investment enables it to participate equally with the common shareholders in increases in Investee’s fair value. Investor also does not expect Investee to pay dividends to its common shareholders during the exercise period; therefore, dividends that could become payable to common shareholders are not expected to result in a difference in the earnings and losses available to the (a) Investor’s investment (warrant) and (b) Investee’s common shares.

Additionally, the current fair value of Investee’s common stock ($21.00) is substantially similar to the current fair value of a warrant to purchase one share of common stock ($20.00, or
$1,000,000/50,000). Therefore, the warrant’s expected participation in Investee’s capital depreciation is substantially similar to the common shareholders’ participation.

As a result, Investor is likely to conclude that, before exercise, the warrant is expected to have risks and rewards of ownership substantially similar to common stock, i.e., the warrant participates in Investee’s earnings (and losses) and capital appreciation (and depreciation) in a manner that is substantially similar to common stock.

Investor should also evaluate the subordination and obligation to transfer value criteria in its determination of whether or not its warrant is in-substance common stock.

**EXAMPLE 4-5**

Investment not expected to participate in risks and rewards of ownership

On January 1, 20X0, Investor purchased a warrant for $150,000. The warrant enables Investor to acquire 50,000 shares of Investee’s common stock at an exercise price of $19.00 per share (total exercise price of $950,000). The warrant is exercisable at any time on or before December 31, 20X0. There are no significant restrictions or contingencies associated with Investor’s ability to exercise the warrant. The warrant does not participate in dividends paid to common shareholders of Investee. However, Investor does not expect Investee to pay dividends to its common shareholders during the exercise period (January 1, 20X0 – December 31, 20X0). On January 1, 20X0, the fair value of Investee’s common stock is $21.00.

Investor has the ability to exercise significant influence over Investee’s operating and financial policies through its investment in Investee.

Is Investor’s investment expected to participate in Investee’s earnings (and losses) and capital appreciation (and depreciation) in a manner that is substantially similar to Investee’s common stock?

**Analysis**

Investor can exercise the warrant and convert its investment to common stock at any time during the exercise period, without any significant restrictions or contingencies; therefore, Investor’s investment enables it to participate equally with the common shareholders in increases in Investee’s fair value. Investor also does not expect Investee to pay dividends to its common shareholders during the exercise period; therefore, dividends that could become payable to common shareholders are not expected to result in a difference in the earnings (and losses) available to the (a) Investor’s investment (warrant) and (b) Investee’s common shares.

The current fair value of Investee’s common stock ($21.00) is substantially different from the current fair value of a warrant to purchase one share of common stock ($3.00, or $150,000/50,000). Therefore, the warrant’s expected participation in Investee’s capital depreciation is substantially different from the common shareholders’ participation. Specifically, Investor’s investment in the warrant has substantially less at risk in the event of capital depreciation than Investee’s common shares.

As a result, Investor is likely to conclude that, before exercise, the warrant is not expected to participate in Investee’s earnings (and losses) and capital appreciation (and depreciation) in a manner
that is substantially similar to common stock. Therefore, the warrant is not in-substance common stock.

Investor would not be required to evaluate the subordination and obligation to transfer value criteria when the risks and rewards of ownership criterion is not met.

**EXAMPLE 4-6**

**Investee not obligated to transfer substantive value**

On January 1, 20X0, Investor purchased 1,000,000 shares of redeemable convertible preferred stock in Investee for $5,000,000. At the date of the investment, 100% of Investee’s common stock was valued at $400,000. The preferred shares can be converted into common shares on a one-for-one basis or else be redeemed for $5,000,000. The common shareholders of Investee do not have a redemption feature.

Investor has the ability to exercise significant influence over Investee’s operating and financial policies through its investment in Investee.

Does the redemption feature obligate Investee to transfer substantive value to Investor that is not also available to common shareholders?

*Analysis*

The $5,000,000 redemption feature is substantive as compared to the fair value of the investment ($5,000,000) on the investment date. However, given that the fair value of the Investee’s common stock was $400,000, Investor is likely to conclude that Investee would not have the ability to pay the redemption amount if exercised. If Investee’s operating results deteriorated, the common shareholders would not be able to absorb significant losses and it would be unlikely that Investee would have the ability to redeem Investor’s preferred stock at the $5,000,000 redemption amount. Therefore, Investor’s redemption feature is not considered substantive as Investee is not expected to transfer substantive value to the Investor.

Investor should also evaluate the subordination and risks and rewards of ownership criteria in its determination of whether or not its investment is in-substance common stock.

**EXAMPLE 4-7**

**Investee obligated to transfer substantive value**

On January 1, 20X0, Investor purchased 1,000,000 shares of redeemable convertible preferred stock in Investee for $5,000,000. At the date of the investment, 100% of Investee’s common stock was valued at $10,000,000. The preferred shares can be converted into common shares on a one-for-one basis or else be redeemed for $5,000,000. The common shareholders of Investee do not have a redemption feature.

Investor has the ability to exercise significant influence over Investee’s operating and financial policies through its investment in Investee.

Does the redemption feature obligate Investee to transfer substantive value to Investor, that is not also available to common shareholders?
Analysis

The $5,000,000 redemption feature is substantive as compared to the fair value of the investment ($5,000,000). The fair value of Investee's common stock was $10,000,000 and Investor concluded when it made the investment that Investee had the ability to pay the redemption amount if exercised. Therefore, Investor's investment in the redeemable convertible preferred stock obligates Investee to transfer substantive value to Investor, that is not available to Investee's common shareholders. As such, the redeemable convertible preferred stock is not in-substance common stock.

Investor would not be required to evaluate the subordination and risk and rewards of ownership criteria as the obligation to transfer value criterion is not met.

4.2.3 Partnerships, joint ventures, and limited liability company investments (equity method)

In accordance with ASC 323-30-25-1, investors in partnerships, unincorporated joint ventures, and limited liability companies should generally account for their investment using the equity method of accounting if the investor has the ability to exercise significant influence over the investee. However, ASC 323-30-S99-1 describes the SEC staff’s view on the application of the equity method to investments in limited partnerships, which requires investments in limited partnerships to be accounted for pursuant to ASC 970-323-25-6. That guidance requires a limited partner to apply the equity method of accounting to its investment unless the limited partner's interest is so minor that the limited partner has virtually no influence over the operating and financial policies of the partnership. See CG 4.2.3.3 for guidance on whether a limited liability company should be viewed as a limited partnership or a corporation for purposes of determining whether the equity method of accounting is appropriate and CG 4.3.1.2 for when an investment is considered more than minor.

The percentage ownership interest in certain partnerships, unincorporated joint ventures, and limited liability companies that is presumed to provide an investor with the ability to influence the operating and financial policies of the investee are different than those that apply for an investment in common stock or in-substance common stock of a corporation. See CG 4.3.1.2 for further information on the presumed levels of ownership interest for these types of entities.

4.2.3.1 General partnerships (equity method)

A general partnership interest in assets, liabilities, earnings, and losses accrues directly to the individual partners. No "corporate veil" exists between the partners and the related investment. General partners in a general partnership usually have the inherent right, absent agreements in partnership articles to the contrary, to influence the operating and financial policies of a partnership. An interest in a general partnership usually provides an investor with the ability to exercise significant influence over the operating and financial policies of the investee. As such, assuming an investor does not hold a controlling financial interest, a general partnership interest is generally accounted for under the equity method of accounting.

4.2.3.2 Limited partnerships and unincorporated joint ventures (equity method)

Interests in a limited partnership or unincorporated joint venture that give an investor the ability to influence the operating and financial policies of the investee in a manner substantially similar to a general partner's interest (i.e., provide an inherent legal right to influence the operating and financial
policies), but do not provide the investor with a controlling financial interest, would generally be accounted for under the equity method of accounting. See CG 4.3.1.2 for further information on the presumed levels of ownership interest that provide investors in limited partnerships and unincorporated joint ventures with the ability to exercise influence.

### 4.2.3.3 Limited liability companies (equity method)

Limited liability companies frequently have characteristics of both corporations and partnerships. Investors must determine whether a limited liability company should be viewed as similar to a corporation or a partnership for purposes of determining whether its investment should be accounted for under the equity method of accounting.

In accordance with ASC 323-30-35-3, a noncontrolling investment in a limited liability company that maintains a specific ownership account (similar to a partnership capital account structure) for each investor should be viewed similarly to an investment in a limited partnership when determining whether the investment provides the investor with the ability to influence the operating and financial policies of the investee.

An investment in a limited liability company that does not maintain specific ownership accounts for each investor, and otherwise resembles the structure of a corporation, should be viewed similar to an investment in a corporation when determining whether to apply the equity method of accounting.

### 4.2.4 Investments for which the equity method is not applicable

The equity method guidance identifies those investments for which the equity method of accounting does not apply.

**ASC 323-10-15-4**

The guidance in this Topic does not apply to any of the following:

a. An investment accounted for in accordance with Subtopic 815-10

b. An investment in common stock held by a nonbusiness entity, such as an estate, trust, or individual

c. An investment in common stock within the scope of Topic 810

d. Except as discussed in paragraph 946-323-45-2, an investment held by an investment company within the scope of Topic 946.

**ASC 323-30-15-4**

This Subtopic does not provide guidance for investments in limited liability companies that are required to be accounted for as debt securities pursuant to paragraph 860-20-35-2.

Each of the investments scoped out of the equity method guidance are discussed in the following sections.
4.2.4.1 Investments accounted for in accordance with ASC 815

Investments that are considered to be derivatives within the scope of ASC 815 are generally accounted for at fair value, unless a scope exception exists or a qualifying election is made by a reporting entity. Investments within the scope of ASC 815 are not accounted for under the equity method. See DH for further information on the accounting for investments within the scope of ASC 815.

4.2.4.2 Investments in common stock held by a non-business entity

Non-business entities, such as an estate, trust, or individual, are not required to account for their investments in common stock that enable them to exercise significant influence over the financial and operating policies of the investee, but which do not represent a controlling financial interest, under the equity method of accounting. The use of the equity method for investments held by such entities is not precluded; rather, this exemption recognizes the diverse nature of non-business entities and the fact that the use of cost or fair value for investments may better present the financial position and changes in financial position of such entities. Non-business entities should consider applying the equity method of accounting to investments held for long-term operating purposes. However, non-business entities generally would not use the equity method of accounting to accounts for their portfolio investments.

4.2.4.3 Investments in common stock within the scope of ASC 810

An investment in common stock that represents a controlling financial interest should be consolidated pursuant to ASC 810, Consolidation. It would not be appropriate for a reporting entity preparing consolidated financial statements to account for an investment in common stock that represents a controlling financial interest under the equity method of accounting. See CG 2 and CG 3 for further information on the accounting for investments that represent a controlling financial interest.

4.2.4.4 Investment in common stock accounted for at fair value

An investment held by an investment company, as defined in ASC 946, is required to be accounted for at fair value, except as described below. Therefore, use of the equity method of accounting by an investment company is not appropriate, regardless of whether or not the investment company has the ability to exercise significant influence over the investee.

The one exception to the general principle in the preceding paragraph is when an investment company has an investment in an operating entity that provides services to the investment company, such as investment advisory or transfer agent services. The purpose of this type of investment is to provide services to the investment company and not to realize a gain on the sale of the investment. These types of investments should be accounted for under the equity method of accounting (not at fair value), provided that the investment otherwise qualifies for use of the equity method.

4.2.4.5 Limited liability entity investments accounted for as debt securities

Investments that can be contractually settled in such a way that the investor may not recover substantially all of its recorded investment are accounted for as debt securities under ASC 320, Investments – Debt Securities. Examples of such investments include beneficial interests, interest-
Equity method of accounting

only strips, and loans or other receivables. These types of securities are outside the scope of the equity method. See TS 4.3 for further information on the accounting for such investments.

4.2.5  **Equity investments for which the fair value option is elected**

ASC 825 permits reporting entities to choose, at specified election dates, to elect the fair value option and measure eligible items at fair value.

**Excerpt from ASC 825-10-15-4**

All entities may elect the fair value option for any of the following eligible items:

a. A recognized financial asset and financial liability...

Equity method investments are financial assets and are generally eligible for the fair value option under ASC 825-10. However, if the equity method investor's interest includes a significant compensatory element (e.g., a performance incentive interest embedded as part of a general partner’s equity interest) and no bifurcation of the compensatory element is required, the investor is precluded from electing the fair value option for its equity investment. For example, if an equity investment included a substantive obligation for the investor to provide services to the investee, the election of the fair value option would not be appropriate as it could result in the acceleration of revenue that should be earned when future services are provided to the investee.

An entity electing to adopt the fair value option for any of its equity method investments is required to present those equity method investments at fair value at each reporting period, with changes in fair value reported in the income statement. In addition, certain disclosures are required in the investor’s financial statements when it has elected the fair value option for an investment that otherwise would be accounted for under the equity method of accounting. See FSP 10.6 for these disclosure requirements.

A reporting entity can generally elect the fair value option for a single eligible investment without needing to elect the fair value option for identical types of investments in other entities. That is, an instrument-by-instrument election is allowed. However, a reporting entity must apply the fair value option to all of its eligible interests in the same entity (e.g., all tranches of equity, debt investments, guarantees), including any previously held interest, when it has elected the fair value option for an equity method investment.

The fair value option can be elected when an investment becomes subject to the equity method of accounting for the first time. For example, an investment may become subject to the equity method of accounting for the first time when an investor obtains significant influence by acquiring an additional investment in an investee or when an investor loses control of an investee, but retains an interest that provides it with the ability to exercise significant influence.

The election of the fair value option is irrevocable, unless an event creating a new election date occurs. Therefore, absent a qualifying event, a reporting entity that elects to adopt the fair value option to account for an equity method investment is precluded from subsequently applying the equity method of accounting to that investment. An investor that elects the fair value option and subsequently loses the ability to exercise significant influence would be required to continue to account for its retained interest on a fair value basis (i.e., the retained investment would not be eligible to be accounted for...
pursuant to other GAAP, such as the cost method of accounting). See FV 5.4.2 for further information on qualifying election dates.

4.2.6 *The proportionate consolidation method*

Proportionate consolidation is appropriate only in limited circumstances and in certain industries. There is a longstanding practice in the construction and extractive industries of investors displaying investments in separate unincorporated legal entities (versus an investment in an incorporated entity or an undivided interest in the separate assets and liabilities) accounted for using the equity method of accounting on a proportionate gross basis, such that the investor’s financial statements reflect the investor’s pro rata share of each of the venture’s assets, liabilities, revenues, and expenses (rather than the one-line treatment) consistent with the guidance in ASC 810-10-45-14. See CG 6.4 for further details.

4.3 *Ability to exercise significant influence (equity method)*

The determination of whether an investment provides an investor with the ability to exercise significant influence over the operating and financial policies of an investee requires judgment considering the facts and circumstances associated with each investment. This determination is required on an ongoing basis. Therefore, an investor’s conclusion regarding whether it has the ability to exercise significant influence over an investee may change. For example, an investee that files for bankruptcy or becomes subject to significant foreign exchange restrictions may cast doubt on an investor’s ability to exercise significant influence, resulting in a change in the investor’s conclusion regarding its ability to exercise significant influence.

In addition, the ability to exercise significant influence over an investee is different from the ability to control an investee. It is common for multiple investors to have the ability to exercise significant influence over the operating and financial policies of an investee, even in instances where there is an investor with a controlling financial interest in an investee.

4.3.1 *Significant influence presumption (equity method)*

The levels of ownership presumed to provide an investor with the ability to exercise significant influence over the operating and financial policies of the investee vary depending on the nature of the investee (e.g., corporation, partnership). Figure 4-1 summarizes these levels of ownership interests by type of investment.

**Figure 4-1**
Summary of levels of ownership generally presumed to exercise significant influence

<table>
<thead>
<tr>
<th>Investment in:</th>
<th>Investor does not own a controlling financial interest, but owns:</th>
<th>Discussed in:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock</td>
<td>20% or more of the outstanding voting securities*</td>
<td>CG 4.2.1,</td>
</tr>
<tr>
<td></td>
<td></td>
<td>CG 4.3.1.1</td>
</tr>
<tr>
<td>In-substance common stock</td>
<td>20% or more of the outstanding voting securities*</td>
<td>CG 4.2.2,</td>
</tr>
<tr>
<td></td>
<td></td>
<td>CG 4.3.1.1</td>
</tr>
<tr>
<td>Investment in:</td>
<td>Investor does not own a controlling financial interest, but owns:</td>
<td>Discussed in:</td>
</tr>
<tr>
<td>---------------------------------------------------</td>
<td>---------------------------------------------------------------</td>
<td>---------------</td>
</tr>
<tr>
<td>General partnership</td>
<td>Any noncontrolling financial interest</td>
<td>CG 4.2.3.1</td>
</tr>
<tr>
<td>Limited partnership or unincorporated joint venture</td>
<td>3-5% or more of a limited partnership or other interest</td>
<td>CG 4.2.3.2,</td>
</tr>
<tr>
<td></td>
<td></td>
<td>CG 4.3.1.2</td>
</tr>
<tr>
<td>Limited liability company or partnership that does not maintain specific ownership accounts for each investor (similar to a corporation)</td>
<td>20% or more of the outstanding voting securities*</td>
<td>CG 4.2.3.3,</td>
</tr>
<tr>
<td></td>
<td></td>
<td>CG 4.3.1.1</td>
</tr>
<tr>
<td>Limited liability company or partnership that maintains a specific ownership account for each investor (similar to a limited partnership)</td>
<td>3-5% or more of the outstanding voting securities</td>
<td>CG 4.2.3.3,</td>
</tr>
<tr>
<td></td>
<td></td>
<td>CG 4.3.1.2</td>
</tr>
</tbody>
</table>

* Other factors may provide an investor that owns less than 20% of the outstanding voting securities of an investee with the ability to exercise significant influence. These factors are discussed in CG 4.3.2. Additionally, other factors may indicate that an investor that owns more than 20% of the outstanding voting securities of an investee does not have the ability to exercise significant influence. These factors are discussed in CG 4.3.3.

### 4.3.1.1 Significant influence for investments in voting common stock, in-substance common stock, and other similar entities

A presumption exists that, in the absence of evidence to the contrary, an investor has the ability to exercise significant influence when it owns (directly or indirectly, as discussed in CG 4.3.1.3) 20% or more of the outstanding voting securities of an investee. This includes investments in common stock, in-substance common stock, and limited liability companies that have characteristics of a corporation (see CG 4.2.3.3). The general presumption of significant influence can be overcome if predominant evidence to the contrary exists. See CG 4.3.3 for further information.

An investor should consider the presumptive levels in evaluating whether or not it has the ability to exercise significant influence; however, the difference between a 20% common stock investment and a 19.9% common stock investment may not be substantive. An investment of less than 20% of the voting stock of an investee, in combination with other indicators, could also provide the investor with the ability to exercise significant influence. See CG 4.3.2 for further information.

The ability of an investor to exercise significant influence is principally derived from voting powers. Therefore, the presumption of significant influence is based on ownership of outstanding securities whose holders have present (not potential) voting privileges. An investor would generally disregard potential voting privileges that may become available in the future (see CG 3.3 for further information regarding consideration of potential voting privileges). In determining whether the presumption of significant influence exists, an investor must consider voting privileges attached to all classes of common stock, preferred stock, and debentures of the investee. The consideration of all voting interests of an investee is solely for the purposes of determining whether the investor has presumptive significant influence over the operating and financial policies of the investor through its voting interests, without consideration of other factors that may indicate the ability to exercise significant influence (e.g., board representation).
**4.3.1.2 Significant influence for limited partnerships and similar entities**

Investments in limited partnerships and similar entities (e.g., a limited liability company that maintains a specific ownership account for each investor) should generally be accounted for under the equity method of accounting unless the investment is so minor that the limited partner may have virtually no influence over the partnership’s operating and financial policies. In practice, investments of more than 3 to 5% are viewed as more than minor. This threshold is different than the level applied for an investment in a corporation (see CG 4.3.1.1).

**Excerpt from ASC 323-30-S99-1**

The SEC staff’s position on the application of the equity method to investments in limited partnerships is that investments in all limited partnerships should be accounted for pursuant to paragraph 970-323-25-6. That guidance requires the use of the equity method unless the investor’s interest “is so minor that the limited partner may have virtually no influence over partnership operating and financial policies.” The SEC staff understands that practice generally has viewed investments of more than 3 to 5 percent to be more than minor.

The use of the equity method in situations where an investor has a less than 3% investment in an entity that maintains separate ownership accounts for each investor should be applied consistently by the investor for all such investments.

**4.3.1.3 Significant influence - direct and indirect investments (equity method)**

All investments in voting securities of an investee should be considered in determining whether an investor has the ability to exercise significant influence over the operating and financial policies of an investee. As such, in addition to its own direct investments in an investee, an investor must also consider its indirect investments in an investee (those that may be held by other of its investees). Example 4-8 through Example 4-13 illustrate the consideration of direct and indirect investments held by an investor in an investee.

**EXAMPLE 4-8**

Investment in each tier qualifies for equity accounting

Company A owns a 20% voting interest in Company B. Company B owns a 20% voting interest in Company C. Therefore, Company A indirectly owns 4% of Company C. No contrary evidence exists to overcome the presumption that Company A has significant influence over Company B and that Company B has significant influence over Company C. All investors and investees are corporate entities.

How should Company A and Company B account for their investments?

*Analysis*

Company B should account for its investment in Company C pursuant to the equity method of accounting. Company A should account for its investment in Company B pursuant to the equity
method of accounting. Company B will record its proportionate share of the earnings or losses of Company C in its financial statements prior to Company A recording its proportionate share of the earnings or losses of Company B in its financial statements; therefore, Company A’s indirect 4% investment in Company C is effectively accounted for using the equity method of accounting.

**EXAMPLE 4-9**

Investment qualifies for equity accounting as a result of ownership by commonly controlled investors

Company A owns an 80% voting interest in Company B and a 70% voting interest in Company C. Company B and Company C each own a 10% voting interest in Company D. Company A’s investments in Company B and Company C represent controlling financial interests. Therefore, Company A consolidates Company B and Company C. All investors and investees are corporate entities.

How should Company A account for its interest in Company D?

**Analysis**

Company A’s economic interest in Company D is 15%: an 8% interest through its controlling financial interest in Company B (80% * 10%) and a 7% interest through its controlling financial interest in Company C (70% * 10%). However, because Company A controls Company B and Company C, Company A controls a 20% voting interest in Company D. As such, Company A’s ownership interest in Company D is, in the absence of evidence to the contrary, presumed to provide it with the ability to exercise significant influence over Company D. Therefore, if the presumption is not overcome, Company A should account for its investment in Company D under the equity method of accounting.

In their standalone financial statements, Company B and Company C would separately evaluate whether they have the ability to exercise significant influence over Company D. The fact that their parent (Company A) controls 20% of Company D’s voting stock through its consolidated subsidiaries (i.e., Company B and Company C) would be a consideration in making such a determination for the separate financial statements of Company B and Company C.

**EXAMPLE 4-10**

Equity accounting despite majority interest through direct and indirect interests

Company A owns a 40% voting interest in each of Company B and Company C. Company B also owns a 30% voting interest in Company C. The remaining interests in Company B and Company C are widely held by other investors and there are no other agreements that affect the voting or management structures of Company B and Company C. All investors and investees are corporate entities.
How should Company A account for its direct and indirect interests in Company C?

**Analysis**

In the absence of any other agreements that affect the voting or management structures of Company B and Company C, Company A’s interest in Company B is not sufficient to direct the actions of Company B’s management, including how it should vote its 30% interest in Company C. As such, despite its economic 52% interest in Company C (40% direct interest, plus its 12% indirect interest (40% * 30%)), Company A would not consolidate Company C in its financial statements. Instead, Company A would account for its investment in Company C under the equity method of accounting.

**EXAMPLE 4-11**

**Investment in investee and direct investment in investee’s consolidated subsidiary**

Company A owns a 25% voting interest in Company B, which is accounted for under the equity method of accounting. Company A also owns a 15% voting interest in Company C. Company B owns an 80% voting interest in Company C, which provides Company B with a controlling financial interest; therefore, Company B consolidates Company C. All investors and investees are corporate entities.

How should Company A account for its direct and indirect interests in Company C?

**Analysis**

Company A has the ability to exercise significant influence over Company B. Company B has control over Company C; therefore, through its ability to exercise significant influence over Company B, Company A also has the ability to exercise significant influence over Company C, despite only having a 15% direct interest. As such, Company A should account for its investment in Company C under the equity method of accounting.
EXAMPLE 4-12

Equity accounting through direct and indirect interests

Company A owns 50% of the common stock of Company B and applies the equity method of accounting since it has significance influence over Company B. Company B owns 22% of the common stock of Company C and applies the equity method of accounting since it has significant influence over Company C. Company A owns (directly) 7% of the common stock of Company C. All investors and investees are corporate entities.

How should Company A account for its direct investment in Company C?

Analysis

Company A’s economic interest in Company C is 18% (7% direct interest plus its 11% indirect interest (50% * 22%)). Given that Company A has the ability to exercise significant influence over the operating and financial policies of Company B (including Company B’s investment in Company C), Company A would apply the equity method of accounting to its 7% direct investment in Company C.

EXAMPLE 4-13

Investment may not qualify for equity accounting despite an economic interest of 20%

Company A owns a 40% voting interest in Company B, which is accounted for under the equity method of accounting. Company A also owns a 16% voting interest in Company C. Company B owns a 10% voting interest in Company C. Individually, Company A and Company B are not able to exercise significant influence over the operating and financial policies of Company C. All investors and investees are corporate entities.

How should Company A account for its direct and indirect interests in Company C?

Analysis
Company A’s economic interest in Company C is 20% (16% direct interest, plus its 4% indirect interest (40% * 10%)). As neither Company A nor Company B have the ability to exercise significant influence over the operating and financial policies of Company C individually, Company A’s 20% economic interest in Company C is not, in and of itself, sufficient to indicate that it has the ability to exercise significant influence over Company C. In this case, Company A’s 40% interest in Company B may not be sufficient to direct the management of Company B, including how it should vote its 10% interest in Company C. Absent other factors that indicate that Company A has the ability to exercise significant influence over Company C (e.g., Company A having representation on Company C’s board), the equity method of accounting would not be appropriate for Company A’s investment in Company C.

**Earnings and losses of an investee’s consolidated subsidiary**

An investor that applies the equity method of accounting to both an interest in an investee and a direct interest in an investee’s consolidated subsidiary should ensure that it does not double count the earnings and losses of the investee’s consolidated subsidiary. In applying the equity method of accounting to its interests, an investor should record its proportionate share of the earnings and losses of the investee and its proportionate share of the earnings and losses of the investee’s consolidated subsidiary. An investor should adjust the financial information of the investee, which will include the results of operations of the investee’s consolidated subsidiaries, prior to determining its proportionate share of the earnings of investee, in order to ensure that it does not double count the earnings and losses of the investee’s consolidated subsidiary.

Example 4-14 illustrates how an investor should record its proportionate share of earnings and losses when it has direct investments in both an investee and the investee’s consolidated subsidiary.

**EXAMPLE 4-14**

**Recording earnings and losses of an interest in an investee and an interest in investee’s consolidated subsidiary**

Company A owns a 20% voting interest in Company B, which is accounted for under the equity method of accounting. Company B owns an 80% voting interest in Company C; therefore, Company B consolidates Company C. Company A also owns a 10% voting interest in Company C and through its ability to exercise significant influence over Company B, Company A also has the ability to exercise significant influence over Company C, despite only having a 10% direct interest. As such, Company A accounts for its investment in Company C under the equity method of accounting.

Company B’s consolidated financial information for the year-ended 20X5 is as follows:

| Income from Company C (100% of Company C’s income) | $250 |
There were no intercompany transactions between Company A, B, and C.

How should Company A record its proportionate share of the earnings and losses of Company B and Company C for the year-ended 20X5?

**Analysis**

Company A should record its proportionate share of earnings of Company B’s controlling interest (20% of $950) and its direct interest in Company C’s earnings (10% of $250) for a total equity in earnings of $215. Company A’s proportionate share of earnings of Company B does not include the net income attributable to the noncontrolling interests in Company C, which includes Company A’s 10% interest; therefore, Company A did not double count the results of operations of Company C.

### Significant influence - passive versus active investor (equity method)

An investor might be a relatively passive investor and still have the ability to exercise significant influence over an investee’s operating and financial policies. That is, an investor does not need to actively exercise and demonstrate such ability. Therefore, it is not appropriate for an investor with an ownership interest of greater than 20% of the outstanding voting securities of an investee to overcome the presumption that it has the ability to exercise significant influence solely on the basis that it (1) has not historically exercised influence, and (2) does not intend to influence the investee in the future. See CG 4.3.3 for further information on contrary evidence that may indicate that the presumptive ability to exercise significant influence of an investee is overcome.

### Significant influence - other indicators (equity method)

The determination of whether an investor has the ability to exercise significant influence over the operating and financial policies of an investee is not limited to the evaluation of voting interests and the level of ownership interest it holds. An investor must consider all relationships and interests (voting and nonvoting) in an investee, including any means through which an investor might influence the operating and financial policies of an investee, such as board representation, veto rights, or voting rights conveyed by a security other than voting common stock. An investor should also consider the capitalization structure of the investee, how significant its investment is to the investee’s capitalization, and the rights and preferences of other investors.

ASC 323-10-15-6 provides a list of indicators that investors should consider when evaluating whether or not it has the ability to exercise significant influence over the operating and financial policies of an investee.
Ability to exercise significant influence over operating and financial policies of an investee may be indicated in several ways, including the following:

a. Representation on the board of directors
b. Participation in policy-making processes
c. Material intra-entity transactions
d. Interchange of managerial personnel
e. Technological dependency
f. Extent of ownership by an investor in relation to the concentration of other shareholdings (but substantial or majority ownership of the voting stock of an investee by another investor does not necessarily preclude the ability to exercise significant influence by the investor).

An investment of less than 20% of the voting stock of an investee leads to a presumption that an investor does not have the ability to exercise significant influence over the operating and financial policies of an investee, unless such ability can be demonstrated. An investor with less than 20% of the voting stock of an investee may demonstrate significant influence through representation on the board of directors, participation in policy-making processes, or in other ways. The determination of whether these factors provide an investor with the ability to exercise significant influence over the financial and operating policies of an investee requires significant judgment. Further discussion of these factors follows.

**4.3.2.1 Significant influence - representation on the board of directors (equity method)**

An investor that has representation on the board of directors can influence the operating and financial policies of an investee through its presence and participation at the board of directors meetings. An investor should evaluate its representation on the board of directors, including specific consideration to board representation that is disproportionate to its ownership interest in the voting securities of an investor. An investor may conclude that the combination of its board representation and less than 20% investment in the voting common stock of an investee provides it with the ability to exercise significant influence over the operating and financial policies of investee. Example 4-15 illustrates how significant influence may be demonstrated through representation on the board of directors.

**EXAMPLE 4-15**

Significant influence demonstrated through representation on the board of directors

Investor has an ownership interest in the voting common stock of Investee that approached 20%. Investor also holds one of five seats on Investee’s board of directors. There are no other indicators that Investor has the ability to exercise significant influence over the operating and financial policies of Investee.

Does Investor have the ability to exercise significant influence over the operating and financial policies of Investee?
Analysis

Investor is likely to conclude that the combination of its voting common stock ownership interest and its representation on the board of directors provides it with the ability to exercise significant influence over the operating and financial policies of Investee. Careful consideration should be given whenever an investor has an ownership interest of less than 20% and investee board representation. The number of representatives and the size of the board as well as the reasons why an investor with a less than 20% ownership interest would have board participation are important considerations when determining whether the equity method of accounting is appropriate.

4.3.2.2 Significant influence - participation in policy-making processes (equity method)

An investor may demonstrate significant influence over an investee through its participation in policy-making processes. An investor should evaluate its ability to participate in the operating and financial decision making of the investee through voting rights, veto rights, or other participating rights or arrangements. For example, in some cases, investors attend board of directors meetings in an “observer” capacity. While the “observer” designation will limit the involvement of an investor’s participation at board of directors meetings (e.g., observers usually cannot vote), attendance alone usually provides the investor with the ability to exercise influence when the investor is able to obtain confidential materials and participate in discussions at the board of directors meetings. Therefore, investors should carefully evaluate whether an observer seat at board of directors meetings provide it with the ability to exercise significant influence. Example 4-16 illustrates how significant influence may be demonstrated through participation in policy-making processes.

EXAMPLE 4-16

Significant influence demonstrated through observer seat on the board of directors

Investor owns a less than 20% ownership interest in the voting common stock of Investee. Investor also has an observer seat on the board of directors. There are no other indicators that Investor has the ability to exercise significant influence over the operating and financial policies of Investee.

Does Investor have the ability to exercise significant influence over the operating and financial policies of Investee?

Analysis

Investor’s observer seat on the board of directors usually provides an investor with the ability to exercise some level of influence. As such, Investor should consider whether the combination of its voting common stock ownership interest and its observer seat on the board of directors provides it with the ability to exercise significant influence over the operating and financial policies of Investee.

4.3.2.3 Significant influence - material intra-entity transactions

An investor may enter into material transactions with an investee. These transactions may provide the investor with the ability to exercise significant influence over the operating and financial policies of the investee, even if the investor's ownership interest in the voting common stock of investee is less than 20%. An investor should carefully evaluate whether such intra-entity transactions provide it with the ability to exercise significant influence. For example, routine intra-entity transactions, such as routine
purchases and sales of non-specialized inventory (e.g., commodity inventories), may not provide an investor with the ability to exercise significant influence, even if those transactions are material. Example 4-17 illustrates how significant influence may be demonstrated through material intra-entity transactions.

**EXAMPLE 4-17**

**Significant influence through material intra-entity transactions**

Investor owns a less than 20% voting interest in Investee. Investee operates in an industry that has relatively few customers. Investee derives 25% of its revenue from sales of highly specialized equipment to Investor pursuant to a long-term sales contract. Investee’s remaining revenue is derived from sales to one other company. There are no other indicators that Investor has the ability to exercise significant influence over the operating and financial policies of Investee.

Does Investor have the ability to exercise significant influence over the operating and financial policies of Investee?

**Analysis**

Investor should carefully consider whether the combination of its voting interest and its long-term purchase agreement provides it with the ability to exercise significant influence over the operating and financial policies of Investee, particularly given the environment in which Investee operates (i.e., Investee sells its highly specialized equipment to a small pool of customers). Therefore, Investor may have significant influence over Investee through a combination of its equity interest and long-term purchase agreement.

**4.3.2.4 Significant influence - interchange of managerial personnel (equity method)**

An investor may demonstrate significant influence over the operating and financial policies of an investee through interchange of managerial personnel. For example, key members of management at an investor may serve in significant management roles (e.g., CEO, CFO) at the investee level. Investor employees serving in such roles at the investee level may provide an investor with the ability to exercise significant influence over the operating and financial policies of the investee; however, careful consideration should be given to the level of responsibilities of such employees in making this determination.

**4.3.2.5 Significant influence - technological dependency (equity method)**

An investee may be technologically dependent upon an investor in the operation of its business. This technological dependence may provide the investor with the ability to exercise significant influence over the operating and financial policies of the investee, even if the investor’s ownership interest in the voting common stock of investee is less than 20%. Example 4-18 illustrates how significant influence may be demonstrated through technological dependency.
EXAMPLE 4-18

Significant influence through technological dependency

Investor owns a less than 20% voting interest in Investee. Investee’s operations are dependent upon a type of technology that is licensed to it by Investor. Investee could license similar technology from a small number of other companies; however, Investee would incur significant termination fees, higher licensing fees, and significant effort to incorporate the alternative technology into its operations.

Does Investor have the ability to exercise significant influence over the operating and financial policies of Investee?

Analysis:

Investor should carefully consider whether the combination of its voting interest and its licensing agreement provides it with the ability to exercise significant influence over the operating and financial policies of Investee, particularly given that Investee is dependent upon Investor’s technology and would have to incur significant costs and effort if Investee were to choose an alternative technology supplier. Therefore, Investor may have significant influence over Investee through a combination of its equity interest and licensing agreement.

4.3.2.6 Significant influence - ownership in relation to the concentration of other shareholdings (equity method)

An investor should consider the extent of its ownership interest in an investee in relation to the ownership interests held by other investors. In some cases, there will be fewer investors, each with significant voting interests in an investee; in other cases, an investee may be more widely held, with no investor holding a significant voting interest.

The existence of an investor that holds a substantial or majority ownership interest in the voting stock of an investee does not necessarily preclude another investor from having the ability to exercise significant influence. For example, absent predominant evidence to the contrary (see CG 4.3.3), an investor that owns a 25% voting interest in an investee is presumed to have the ability to exercise significant influence over the operating and financial policies of the investee, even if one other investor owns the remaining 75% voting interest in the investee.

An investor that holds a less than 20% voting interest in a widely held investee may be able to demonstrate its ability to exercise significant influence when all other investors, individually, have substantially smaller ownership interests. Judgment will need to be applied when evaluating whether or not the extent of an investor’s investment in relation to the investee’s other shareholdings indicates the ability to exercise significant influence.

4.3.3 Significant influence - predominant evidence to the contrary (equity method)

As discussed in CG 4.3.1, a presumption exists that, in the absence of predominant evidence to the contrary, an investor has the ability to exercise significant influence when it owns (directly or indirectly) 20% or more of the outstanding voting securities of an investee. ASC 323-10-15-10 provides a list of indicators that may represent evidence that an investor may be unable to exercise significant influence over the operating and financial policies of an investee, despite an ownership interest of greater than 20% of the outstanding voting securities.
Evidence that an investor owning 20 percent or more of the voting stock of an investee may be unable to exercise significant influence over the investee’s operating and financial policies requires an evaluation of all the facts and circumstances relating to the investment. The presumption that the investor has the ability to exercise significant influence over the investee’s operating and financial policies stands until overcome by predominant evidence to the contrary. Indicators that an investor may be unable to exercise significant influence over the operating and financial policies of an investee include the following:

a. Opposition by the investee, such as litigation or complaints to governmental regulatory authorities, challenges the investor’s ability to exercise significant influence.

b. The investor and investee sign an agreement (such as a standstill agreement) under which the investor surrenders significant rights as a shareholder. (Under a standstill agreement, the investor usually agrees not to increase its current holdings. Those agreements are commonly used to compromise disputes if an investee is fighting against a takeover attempt or an increase in an investor’s percentage ownership. Depending on their provisions, the agreements may modify an investor’s rights or may increase certain rights and restrict others compared with the situation of an investor without such an agreement.)

c. Majority ownership of the investee is concentrated among a small group of shareholders who operate the investee without regard to the views of the investor.

d. The investor needs or wants more financial information to apply the equity method than is available to the investee’s other shareholders (for example, the investor wants quarterly financial information from an investee that publicly reports only annually), tries to obtain that information, and fails.

e. The investor tries and fails to obtain representation on the investee’s board of directors.

The list in the preceding paragraph is illustrative and is not all-inclusive. None of the individual circumstances is necessarily conclusive that the investor is unable to exercise significant influence over the investee’s operating and financial policies.

However, if any of these or similar circumstances exists, an investor with ownership of 20 percent or more shall evaluate all facts and circumstances relating to the investment to reach a judgment about whether the presumption that the investor has the ability to exercise significant influence over the investee’s operating and financial policies is overcome. It may be necessary to evaluate the facts and circumstances for a period of time before reaching a judgment.

Predominant evidence to overcome the presumption of significant influence may be indicated in ways other than those specifically described above. For example, if an investor owns a 20% interest in a foreign investee that operates in a country that has imposed exchange restrictions or in a market that creates other significant uncertainties, the investor may be able to overcome the presumption that it has the ability to exercise significant influence over an investee’s operating and financial policies.

None of the above or other individual circumstances is necessarily conclusive that an investor is unable to exercise significant influence over an investee’s operating and financial policies. As stated in
the guidance above, predominant evidence is necessary to overcome the presumption of significant influence. An evaluation of all facts and circumstances related to the investment is required if any of these or similar circumstances exist in order to reach a judgment about whether the presumption of significant influence over operating and financial policies is overcome.

4.3.3.1 Significant influence - examples of contrary evidence to overcome presumption (equity method)

Example 4-19 and Example 4-20 illustrate the evaluation of whether contrary evidence exists to overcome the presumption of an investor’s ability to exercise significant influence over the operating and financial policies of an investee.

EXAMPLE 4-19
Contrary evidence not sufficient to overcome presumption

Investor owns a 25% voting interest in Investee. Investor is a passive investor and has not exercised its ability to influence the operating and financial policies of Investee in the past. Further, Investor does not intend to influence the operating and financial policies of Investee in the future. No other contrary evidence exists to overcome the presumption of significant influence.

Is there predominant evidence to the contrary to overcome the presumption that Investor has the ability to exercise significant influence over the operating and financial policies of Investee?

Analysis

An investor with the ability to exercise significant influence over an investee should apply the equity method of accounting. An evaluation of all facts and circumstances related to the investment is required if any of the factors described in ASC 323-10-15-10 (or other similar factors) exist in order to reach a judgment about whether the presumption of significant influence is overcome. The fact that Investor (1) has not exercised its ability to influence Investee in the past and (2) does not intend to influence Investee in the future is not contrary evidence to overcome the presumption that Investor has the ability to exercise significant influence.

EXAMPLE 4-20
Contrary evidence exists to overcome presumption

Investor owns a 20% voting interest in Investee. The majority ownership of Investee is concentrated among a small group of shareholders who operate Investee without regard to the views of Investor. Investor has repeatedly tried to obtain representation on the Investee’s board of directors, but it has been unsuccessful in those attempts. Investee has also actively and publicly resisted the exercise of influence by Investor.

Is there sufficient evidence to the contrary to overcome the presumption that Investor has the ability to exercise significant influence over the operating and financial policies of Investee?

Analysis

Investor may be able to conclude that there is predominant evidence to overcome the presumption that it has the ability to exercise significant influence as a result of (1) the small group of shareholders
that own a majority ownership interest in Investee operating Investee without regard to the views of Investor, (2) Investor’s failed attempts to obtain representation on the Investee’s board of directors, and (3) Investee’s active and public resistance to the exercise of influence by Investor. An evaluation of all other facts and circumstances relating to the investment would be required prior to concluding whether the presumption of significant influence is overcome.

4.3.4 **Significant influence, but precluded from using the equity method of accounting**

An investor may have significant influence over the operating and financial policies of an investee through an investment that does not qualify as common stock or in-substance common stock. In these cases, application of the equity method of accounting to such investment would not be appropriate. For example, if an investor acquired voting preferred stock of an investee and concluded that its investment is not in-substance common stock, absent other investments in common stock or in-substance common stock of that investee, investor would be precluded from applying the equity method of accounting even if the investor exerts significant influence. In this case, the investor would account for its investment under other applicable accounting guidance (e.g., ASC 320, *Debt Securities* or ASC 321, *Equity Securities*).

4.4 **Initial measurement of an investment in common stock or in-substance common stock (equity method)**

An investment in common stock or in-substance common stock to be accounted for using the equity method should initially be measured at cost, except when an investor receives an equity method investment as consideration for loss of control of a nonfinancial asset or business or for transfer of an equity method investment. Transactions subject to ASC 610-20, *Other Income—Gains and Losses from the Derecognition of Nonfinancial Assets*, ASC 810, or ASC 860, *Transfers and Servicing*, are initially measured at fair value.

**Excerpt from ASC 323-10-30-2**

Except as provided in the following sentence, an investor shall measure an investment in the common stock of an investee (including a joint venture) initially at cost in accordance with the guidance in Section 805-50-30. An investor shall initially measure, at fair value, the following:

a. A retained investment in the common stock of an investee (including a joint venture) in a deconsolidation transaction in accordance with paragraphs 810-10-40-3A through 40-5

b. An investment in the common stock of an investee (including a joint venture) recognized upon the derecognition of a distinct nonfinancial asset or distinct in substance nonfinancial asset in accordance with Subtopic 610-20.

**ASC 860-20-30-1**

The transferor shall initially measure at fair value any asset obtained (or liability incurred) and recognized under paragraph 860-20-25-1.

Investments in common stock are recognized in the statement of financial position using a cost accumulation model. The initial measurement of an investment includes the cost of the investment.
itself (e.g., cash or other consideration paid to purchase the investment) and all direct transaction costs incurred by the investor in order to acquire the investment. Direct transaction costs are generally out-of-pocket costs paid to third parties directly associated with the acquisition of an investment.

Examples of direct transaction costs include appraisal fees (e.g., fees paid to third party valuation specialist to assist management in determining whether to invest in an investee and to determine its fair value), legal and consulting fees (e.g., fees paid to external legal counsel to draft and review investment agreements in order to consummate the transaction), and finder’s fees (e.g., fees paid to a broker to identify and facilitate the acquisition of an interest in the investee). All costs that are not directly associated with the acquisition of an investment, including all internal costs, should be expensed as incurred.

The treatment of transaction costs incurred in connection with the acquisition of an investment in common stock accounted for under the equity method of accounting is different from the treatment of transaction costs incurred in connection with the acquisition of a business, which are required to be expensed as incurred pursuant to ASC 805. See BCG 2 for further information regarding business combinations.

4.4.1 Contribution of noncash assets for an equity interest in an investee (equity method)

The accounting for an investor’s contribution of cash in exchange for an equity interest in an investee is generally straightforward; however, investors commonly contribute noncash assets in exchange for an equity interest in an investee. The nature of the contributed noncash assets will determine the accounting model the investor should apply. This section focuses on the accounting for noncash contributions that are exchanged for an equity interest in an investee.

4.4.1.1 Contribution of nonfinancial assets that do not represent a business to a noncustomer (equity method)

An investor should apply the guidance in ASC 323-10-30-2 and ASC 610-20 when it transfers nonfinancial assets that together are not a business to a noncustomer as consideration for a noncontrolling equity interest in an investee. See PPE 5.5 for guidance on the transfer of nonfinancial assets in accordance with ASC 610-20.

4.4.1.2 Contribution of nonfinancial assets that meet the definition of a business (equity method)

An investor may contribute nonfinancial assets that meet the definition of a business in exchange for a noncontrolling equity interest in the investee. In these cases, the investor should follow the guidance in ASC 323-10-30-2 and ASC 810-10-40-5, which will result in the recognition of a gain or loss measured as the difference between the fair value of any consideration received (i.e., the equity interest in the investee) and the carrying amount of the former subsidiary's assets and liabilities (i.e., the contributed business). See BCG 6 for further discussion.

The guidance in ASC 810-10-40-3A states that partial sales of in substance real estate are excluded from the scope of ASC 810, regardless of whether the real estate underlying the transaction is considered a business and should continue to be accounted for in accordance with ASC 360-20 or ASC 976-605. However, this guidance was amended when the FASB issued ASC 610-20. Upon adoption of ASC 610-20, the guidance in ASC 810-10-40-3A will state that the sale of real estate that is a business is within the scope of ASC 810. See CG 4.4.1.3 for further discussion.
4.4.1.3 Contribution of real estate to a noncustomer (equity method)

An investor should apply the guidance in ASC 323-10-30-2 and ASC 610-20 when it contributes real estate that is not a business to a noncustomer for a noncontrolling equity interest in an investee. See PPE 5.5 for guidance on the transfer of nonfinancial assets that do not represent a business.

ASC 970-323-30-3 illustrates the initial accounting for the contribution of real estate that is not a business to a venture.

ASC 970-323-30-3

An investor that contributes real estate to the capital of a real estate venture generally should record its investment in the venture at fair value when the real estate is derecognized, regardless of whether the other investors contribute cash, property, or services. The transaction shall be accounted for in accordance with the guidance in paragraphs 360-10-40-3A through 40-3C. Some transactions are sales of an ownership interest that result in an entity being an investor in a real estate venture. An example of such a transaction includes one in which investor A contributes real estate with a fair value of $2,000 to a venture and investor B contributes cash in the amount of $1,000. The real estate is not considered a business or nonprofit activity and, therefore, is within the scope of Subtopic 610-20 on gains and losses from the derecognition of nonfinancial assets. Investor A immediately withdraws the cash contributed by investor B and, following such contributions and withdrawals, each investor has a 50 percent interest in the venture (the only asset of which is the real estate). Assuming investor A does not have a controlling financial interest in the venture, investor A applies the guidance in paragraphs 610-20-25-5 and 610-20-25-7. When investor A meets the criteria to derecognize the property, investor A measures its retained ownership interest at fair value consistent with the guidance in paragraph 610-20-32-4 and includes that amount in the consideration used in calculating the gain or loss on derecognition of the property.

4.4.1.4 Contribution of intellectual property to a noncustomer (equity method)

An investor may transfer intellectual property that is not a business to an investee that is not a customer in return for an equity method investment in the investee. If the investor transfers intellectual property to the investee, the investor would account for the transfer using the guidance in ASC 323-10-30-2 and ASC 610-20. See PPE 5.4 for guidance on the transfer of nonfinancial assets that do not represent a business in accordance with ASC 610-20.

4.4.1.5 Exchange of an equity method investment for another

ASC 860 establishes accounting and reporting standards for transfers and servicing of financial assets. Equity method investments are financial assets; therefore, transfers of equity method investments are within the scope of ASC 860 provided they meet the definition of a transfer, as defined in ASC 860.

ASC 860-10-55-3

The guidance in this Topic applies to the following transactions and activities, among others:

a. All loan participations

b. Transfers of equity method investments

c. Transfers of cost-method investments
d. With respect to the guidance in paragraph 860-10-40-5 only, transfers of financial assets in desecuritization transactions.

**Definition from ASC 860-10-20**

Transfer: The conveyance of a noncash financial asset by and to someone other than the issuer of that financial asset.

The sale of investee shares accounted for under the equity method of accounting must meet all of the criteria in ASC 860-10-40-5 in order to be accounted for as a sale and to recognize a full gain or loss. This guidance states that a transfer should be accounted for as a sale, with full gain or loss recognition, if and only if all of the following conditions are met:

- The transferred financial assets have been isolated from the transferor
- The transferee has the right to pledge or exchange the assets
- The transferor, its consolidated affiliates, or its agents do not maintain effective control over the transferred assets

The guidance in ASC 845-10-55-2 (related to nonmonetary transactions) states that exchanges of one equity method investment for another equity method investment must also be accounted for pursuant to the guidance in ASC 860. However, in certain circumstances, the change in interest guidance discussed in CG 4.7 may more appropriately reflect the substance of an exchange of one equity method investment for another equity method investment. This may be the case when the exchange is economically a dilution event. If the exchange is economically a dilution event, the issuer (investee) is deemed to have effectively issued additional shares to other investors. Such an exchange is not in the scope of ASC 860 and the change in interest guidance would be applicable.

Example 4-21 illustrates an example of when it might be appropriate to account for an exchange of one equity method investment for another equity method investment as a change in interest transaction, resulting in partial gain recognition. Example 4-22, on the other hand, illustrates an example of when it might be appropriate to account for an exchange of one equity method investment for another equity method investment as a sale under ASC 860, resulting in full gain recognition.

**EXAMPLE 4-21**

Exchange of one equity method investment for another equity method investment accounted for as a change in interest transaction

Investors A, B, and C own the following interests in Investee, an operating company engaged in the manufacturing and sale of goods:

<table>
<thead>
<tr>
<th>Shareholder</th>
<th>Shares</th>
<th>Percent ownership</th>
<th>Book value of underlying net assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investor A</td>
<td>40</td>
<td>40%</td>
<td>$400</td>
</tr>
<tr>
<td>Investor B</td>
<td>30</td>
<td>30%</td>
<td>300</td>
</tr>
<tr>
<td>Investor C</td>
<td>30</td>
<td>30%</td>
<td>300</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>100</td>
<td>100%</td>
<td><strong>$1,000</strong></td>
</tr>
</tbody>
</table>
Assume no basis difference exists between Investor A’s investment balance and its underlying interest in the net assets of Investee (i.e., both are $400). Investors A, B, and C created a new company (“Newco”), which had no assets, liabilities, or operations immediately subsequent to formation. Newco issued 15 shares (15% interest) to each of Investors D and E in exchange for $1,500. The proceeds will be used to fund Newco’s operations. At the same time, Investors A, B, and C exchange their equity interests in Investee for equity interests in Newco. Investors A, B, and C receive 28, 21, and 21 shares in Newco, respectively. Immediately after these transactions, the shareholdings of Newco are summarized in the table below.

<table>
<thead>
<tr>
<th>Shareholder</th>
<th>Shares</th>
<th>Percent ownership</th>
<th>Book value of underlying net assets, prior to change in interest computation</th>
<th>Fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investor A</td>
<td>28</td>
<td>28%</td>
<td>$400</td>
<td>$2,800</td>
</tr>
<tr>
<td>Investor B</td>
<td>21</td>
<td>21%</td>
<td>300</td>
<td>2,100</td>
</tr>
<tr>
<td>Investor C</td>
<td>21</td>
<td>21%</td>
<td>300</td>
<td>2,100</td>
</tr>
<tr>
<td>Investor D</td>
<td>15</td>
<td>15%</td>
<td>1,500</td>
<td>1,500</td>
</tr>
<tr>
<td>Investor E</td>
<td>15</td>
<td>15%</td>
<td>1,500</td>
<td>1,500</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100</strong></td>
<td><strong>100%</strong></td>
<td><strong>$4,000</strong></td>
<td><strong>$10,000</strong></td>
</tr>
</tbody>
</table>

How should Investor A account for its exchange of a 40% interest in Investee for a 28% interest in Newco?

**Analysis**

Newco is effectively the same business as that of Investee because Newco has no additional assets, liabilities, or operations, except for the cash paid by Investors D and E to obtain 15% ownership interests in Newco. Therefore, Investor A has an investment in the same underlying business both before and after the transaction; however, its ownership interest has been diluted by virtue of Newco’s issuance of shares to Investors D and E for cash. As such, Investor A should account for this exchange as a change in interest transaction. Investor A should recognize a change in interest gain of $720, calculated as the difference between Investor A’s (1) proportionate share (28%) of Newco’s book value ($4,000) and (2) book value of its ownership interest in Investee ($400). Investor A’s change in interest gain can also be calculated as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Calculation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value per share</td>
<td>$100.00</td>
</tr>
<tr>
<td>Investor A’s book value per share</td>
<td>14.29</td>
</tr>
<tr>
<td>Excess paid over book value per share</td>
<td>85.71</td>
</tr>
<tr>
<td>Shares issued to Investors D and E by Newco</td>
<td>30</td>
</tr>
<tr>
<td>Investor A’s % ownership in Newco</td>
<td>28%</td>
</tr>
<tr>
<td><strong>Investor A’s change in interest gain</strong></td>
<td><strong>$720</strong></td>
</tr>
</tbody>
</table>
A – Investors D and E each paid $1,500 in exchange for 15 shares, or $100 per share.

B – Prior to Newco’s issuance of shares to Investors D and E, Investor A held 28 shares of Newco with a book value of $400, or $14.29 per share.

C – Investor A’s change in interest gain is calculated as the product of (1) the excess paid by Investor D and E over the book value per share ($85.71), (2) the number of shares issued to Investors D and E by Newco (30 shares), and (3) Investor A’s % ownership in Newco (28%).

Investor A’s cost basis in its continuing investment in Newco is $1,120 (28% of $4,000).

**EXAMPLE 4-22**

Exchange of one equity method investment for another equity method investment accounted for as a sale pursuant to ASC 860

Investors A, B, and C own the following interests in Investee, an operating company engaged in the manufacturing and sale of airplanes:

<table>
<thead>
<tr>
<th>Shareholder</th>
<th>Shares</th>
<th>Percent ownership</th>
<th>Book value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investor A</td>
<td>40</td>
<td>40%</td>
<td>$400</td>
</tr>
<tr>
<td>Investor B</td>
<td>30</td>
<td>30%</td>
<td>300</td>
</tr>
<tr>
<td>Investor C</td>
<td>30</td>
<td>30%</td>
<td>300</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100</strong></td>
<td><strong>100%</strong></td>
<td><strong>$1,000</strong></td>
</tr>
</tbody>
</table>

Assume no basis difference exists between Investor A’s investment balance and its underlying interest in the net assets of Investee (i.e., both are $400). Investors A, B, and C created a new limited partnership (“Newco LP”), which had no assets, liabilities, or operations immediately subsequent to formation. Investors A, B, and C exchange their equity interests in Investee for equity interests in Newco LP. At the same time, Investors D and E each contributed businesses in exchange for 45% interests in Newco LP. The business contributed by Investor D manufactures and sells speed boats and has a fair value of $22,500. The business contributed by Investor E manufactures and sells off-road vehicles and has a fair value of $22,500. Immediately after these transactions, the shareholdings of Newco LP are summarized in the table below.

<table>
<thead>
<tr>
<th>Shareholder</th>
<th>Percent ownership</th>
<th>Fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investor A</td>
<td>4%</td>
<td>$2,000</td>
</tr>
<tr>
<td>Investor B</td>
<td>3%</td>
<td>1,500</td>
</tr>
<tr>
<td>Investor C</td>
<td>3%</td>
<td>1,500</td>
</tr>
<tr>
<td>Investor D</td>
<td>45%</td>
<td>22,500</td>
</tr>
<tr>
<td>Investor E</td>
<td>45%</td>
<td>22,500</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100%</strong></td>
<td><strong>$50,000</strong></td>
</tr>
</tbody>
</table>
How should Investor A account for its exchange of a 40% interest in Investee for a 4% interest in Newco LP?

**Analysis**

Investor A will account for its 4% interest in Newco LP under the equity method of accounting (see CG 4.3.1.2). Newco LP engages in the manufacturing and sale of (1) airplanes (i.e., the operations of Investee), (2) speed boats (i.e., the operations of the business contributed by Investor D), and (3) off-road vehicles (i.e., the operations of the business contributed by Investor E). The speed boat and off-road vehicles businesses are substantially more material than the operations of the airplane business. As such, the operations of Newco LP are not substantially the same as the operations of Investee.

Investor A is likely to conclude that it is appropriate to account for the exchange of its equity interest in Investee for the equity interest in Newco LP pursuant to the guidance in ASC 860, which results in full gain recognition. In practice, significant judgment should be applied in determining whether accounting for an exchange of equity method investments as a change in interest transaction or a sale more closely reflects the economics of the transaction. If Investor A concludes that it should account for this exchange under ASC 860, Investor A should recognize a gain on the sale of its equity interest in Investee equal to the difference between the selling price ($2,000) and the carrying value of the interest sold at the time of sale ($400).

Investor A’s cost basis in its investment in Newco LP is $2,000.

In any exchange of equity method investments, the facts and circumstances must be carefully evaluated to determine if the transaction is a full sale (transfer under ASC 860), which results in full gain recognition, or partial sale (change in interest transaction), which results in partial gain recognition, of the transferred equity method investment.

**4.4.2 Contingent consideration in acquiring an investment (equity method)**

ASC 323 prescribes the model for recording contingent consideration issued in the acquisition of an equity method investment.

**ASC 323-10-25-2A**

If an equity method investment agreement involves a contingent consideration arrangement in which the fair value of the investor’s share of the investee’s net assets exceeds the investor’s initial cost, a liability shall be recognized.

**ASC 323-10-30-2A**

Contingent consideration shall only be included in the initial measurement of an equity method investment if it is required to be recognized by specific authoritative guidance other than Topic 805.
**ASC 323-10-30-2B**

A liability recognized under paragraph 323-10-25-2A shall be measured initially at an amount equal to the lesser of the following:

(a) The maximum amount of contingent consideration not otherwise recognized

(b) The excess of the investor’s share of the investee’s net assets over the initial cost measurement (including contingent consideration otherwise recognized).

**ASC 323-10-35-14A**

If a contingency is resolved relating to a liability recognized in accordance with the guidance in paragraph 323-10-25-2A and the consideration is issued or becomes issuable, any excess of the fair value of the contingent consideration issued or issuable over the amount that was recognized as a liability shall be recognized as an additional cost of the investment. If the amount initially recognized as a liability exceeds the fair value of the consideration issued or issuable, that excess shall reduce the cost of the investment.

If contingent consideration is required to be recognized by specific authoritative guidance other than ASC 805 (e.g., ASC 480, Distinguishing Liabilities from Equity, ASC 450, Contingencies, or ASC 815), it should be initially recorded as part of the equity method investment based on the guidance being applied. For example, a derivative within the scope of ASC 815 (see DH 2 for the characteristics of a derivative instrument) that requires recognition under this guidance would be initially recorded at fair value and included in the basis of the equity method investment. Subsequently, the derivative would represent a separate unit of account from the equity method investment, with changes in fair value being recorded in the income statement and not as an increase or decrease to the basis of the equity method investment.

If an investment agreement involves a contingent consideration arrangement in which the fair value of the investor’s share of the investee’s net assets exceeds the investor’s initial cost pursuant to ASC 323-10-25-2A, a liability shall be recognized equal to the lesser of:

- The maximum amount of contingent consideration not otherwise recognized, and
- The excess of the investor’s share of the investee’s net assets over the initial cost measurement (including contingent consideration otherwise recognized under ASC 323-10-30-2A).

Subsequent accounting for contingent consideration recognized under this model requires that, upon resolution of the contingency, the fair value of the consideration paid should be compared to the initial liability recorded. If the consideration paid exceeds the liability initially recorded, that amount should be recognized as an additional cost of the investment. If the consideration paid is less than the liability initially recorded, the difference should reduce the cost of the investment.

The accounting for contingent consideration issued in the acquisition of an equity method investment, as described above, is different from the contingent consideration model associated with business combinations. See BCG 2.6.4 for information on accounting for contingent consideration in a business combination.

Example 4-23 and Example 4-24 illustrate the accounting for contingent consideration associated with the acquisition of an investment accounted for under the equity method.
EXAMPLE 4-23
Contingent consideration recognized pursuant to ASC 815

Investor acquired a 20% interest in the voting common stock of Investee for cash consideration of $100 and a contingent consideration arrangement meeting the definition of a derivative with a fair value of $10. Investor’s interest in Investee provides it with the ability to exercise significant influence over the operating and financial policies of Investee. Therefore, Investor accounts for its investment in Investee pursuant to the equity method of accounting.

At what amount should Investor’s investment in the common stock of Investee be measured on the date of acquisition?

Analysis

The contingent consideration arrangement is required to be recognized pursuant to ASC 815. Therefore, the initial cost of Investor’s investment should be measured at $110 ($100 [cash consideration] plus $10 [fair value of derivative]). Subsequent changes in the fair value of the contingent consideration would be accounted for pursuant to ASC 815 and separate from the equity method investment.

EXAMPLE 4-24
Contingent consideration when the fair value of the Investor’s share of the Investee’s net assets exceeds the investor’s initial cost

On January 1, 20X0, Investor acquired a 20% interest in the voting common stock of Investee for cash consideration of $100. On the date of acquisition, the fair value of Investor’s share of the Investee’s net assets was $120. Investor is required to pay additional consideration of $25 to Investee if certain performance targets are met. Contingent consideration was not required to be recorded upon acquisition pursuant to other specific authoritative guidance.

At what amount should Investor’s investment in the common stock of Investee be measured on the date of acquisition?

Analysis

The investor should record a liability for the contingent consideration equal to the lesser of (1) the maximum amount of contingent consideration not otherwise recognized of $25 and (2) the excess of the fair value of Investor’s share of the Investee’s net assets over the cost of Investor’s investment of $20 ($120 - $100). As such, Investor should initially record its investment in the common stock of Investee at $120. When the contingency is resolved, the difference between the contingent consideration liability recorded at the acquisition date and the consideration paid should be recorded as an increase or decrease to the basis of the equity method investment.

4.4.3 Guarantee issued by investor on behalf of equity method investee

An investor may issue a guarantee to a third party on behalf of an equity method investee. An investor should evaluate whether the guarantee affects its accounting for the equity method investee. This analysis will at least require the investor to consider the accounting guidance in ASC 460, Guarantees.
At the inception of a guarantee, a guarantor shall recognize in its statement of financial position a liability for that guarantee. This Subsection does not prescribe a specific account for the guarantor’s offsetting entry when it recognizes a liability at the inception of a guarantee. That offsetting entry depends on the circumstances in which the guarantee was issued. See paragraph 460-10-55-23 for implementation guidance.

Excerpt from ASC 460-10-55-23

Although paragraph 460-10-25-4 does not prescribe a specific account, the following illustrate a guarantor’s offsetting entries when it recognizes the liability at the inception of the guarantee:

... 

c. If the guarantee were issued in conjunction with the formation of a partially owned business or a venture accounted for under the equity method, the recognition of the liability for the guarantee would result in an increase to the carrying amount of the investment.

An investor that issues a guarantee on behalf of its equity method investee should recognize a liability (credit) in its financial statements pursuant to ASC 460. Judgment must be applied in determining the line item in which the offsetting debit should be recorded in the investor’s financial statements.

The investor should first determine the consideration received, if any, for issuing the guarantee. If no consideration for the guarantee was received, the investor should determine the amount of the guarantee related to its ownership interest in the equity method investee. This portion of the guarantee should be recognized as an increase in the carrying amount of its investment in its investee pursuant to the guidance in ASC 460-10-55-23.

Any portion of the guarantee related to other investors’ ownership interests in the investee should be recorded as expense in the investor’s financial statements by analogy to the guidance in ASC 323-10-25-3, which addresses the accounting for stock-based compensation based on an investor’s stock awarded to employees of an investee in certain facts and circumstances. See CG 4.5.5.4 for further information.

For example, if an investor owning 25% of the voting stock of an investee issues a guarantee on behalf of the investee with a fair value of $100, the investor should account for such guarantee as follows:

- The portion of the guarantee related to its ownership interest should be recognized as an increase in the basis of its investment ($25, calculated as its 25% ownership interest multiplied by the $100 fair value of guarantee)

- The portion of the guarantee related to other investors’ ownership interests should be recognized as expense ($75, calculated as the other investors’ 75% ownership interests multiplied by the $100 fair value of guarantee).

See Example 2-5 in FG 2 for further information on an investor’s accounting for a guarantee issued on behalf of an investee.
4.4.4 **Balance sheet classification of an equity method investment**

In accordance with ASC 323-10-45-1, an investment that qualifies for the equity method of accounting should be presented in the balance sheet of an investor as a single amount.

The investor generally cannot record its share of each asset and liability of the investee (i.e., the so called “expanded equity” or “proportionate consolidation” approach) in its balance sheet. Proportionate consolidation is only used in certain industries when accounting for unincorporated undivided interests where the investor legally owns a proportionate share of each asset and is obligated for its proportionate share of each liability. This method would not be appropriate for an investment in a corporate investee because the investor owns an interest in the corporate investee as a whole and does not have a proportionate legal interest in each asset and liability. See CG 6 for further information on the proportionate consolidation approach. Also, see FSP 10 for further information on the financial statement presentation and disclosure related to equity method investments.

4.4.5 **Accounting for basis differences and equity method goodwill**

The purchase price paid by an investor for an ownership interest in the voting common stock of an investee is presumed to be reflective of fair value (i.e., the price that would be received to sell an asset in an orderly transaction between market participants). The underlying assets and liabilities of the investee are recorded at historical cost; therefore, a basis difference between the cost of an investment and the investor’s share of the net assets of the investee as reflected by the investee (historical carrying value) usually exists.

**ASC 323-10-35-13**

A difference between the cost of an investment and the amount of underlying equity in net assets of an investee shall be accounted for as if the investee were a consolidated subsidiary. Paragraph 350-20-35-58 requires that the portion of that difference that is recognized as goodwill not be amortized. However, if a private company elects the accounting alternative in Subtopic 350-20 on goodwill, the portion of that difference that is recognized as goodwill shall be amortized on a straight-line basis over 10 years, or less than 10 years if the entity demonstrates that another useful life is more appropriate. Paragraph 350-20-35-59 explains that equity method goodwill shall not be reviewed for impairment in accordance with paragraph 350-20-35-58. However, equity method investments shall continue to be reviewed for impairment in accordance with paragraph 323-10-35-32.

4.4.5.1 **Assignment of basis differences to identified assets and liabilities (equity method)**

The basis difference between the cost of an investment and the investor’s share of the net assets (underlying equity in net assets) of the investee is generally attributable to multiple assets and liabilities of the investee. An investor should identify those assets and liabilities giving rise to the basis difference, including those assets and liabilities not recorded in the investee’s general ledger (e.g., unrecognized intangible assets), and account for the differences in its equity method memo accounts according to their nature.

For example, the difference between an investor’s proportionate share of the fair value and the carrying value of investee-owned property, plant, and equipment is a basis difference that an investor must account for in its equity method accounting. If the investor’s proportionate share of the fair value exceeds the book value of the investee owned property, plant, and equipment, the investor should
track such difference in its equity method memo accounts and subsequently amortize the excess as a reduction to its equity in earnings of the investee. In this case, the amortization of the basis difference results in additional expense for the investor, which reflects the investor’s higher cost basis in the investee’s property, plant, and equipment. While this example represents a positive basis difference, basis differences can be positive or negative.

This process for determining basis differences is similar to the application of the acquisition method to a business combination pursuant to ASC 805, Business Combinations. See BCG 2 for further information on the application of the acquisition method. As illustrated in the example in the preceding paragraph, subsequent to acquisition, basis differences assigned to those identified assets and liabilities will be recognized into equity in earnings (income statement), with a corresponding increase or decrease to the equity investment balance (balance sheet). See CG 4.5.5.1 for further information on the subsequent accounting for identified basis differences.

An investor must also account for the deferred tax consequences associated with the identified basis differences between the fair value and book value of the investee’s assets and liabilities. For example, the cost of an investment may exceed the investor’s proportionate share of the investee’s net assets because the fair value of the investee’s fixed assets is greater than its book value. As such, the investor would track that basis difference in its equity method memo accounts. The investor must also calculate the associated deferred tax liability in its equity method memo accounts, which, at the acquisition date, is equal to the product of (1) the excess of fair value over book value of the fixed assets and (2) the investee’s applicable tax rate. Subsequently, the investor would amortize the excess basis difference and recognize the associated deferred tax effects in determining its equity in earnings of investee. See TX 11 for further information.

Investments accounted for under the equity method for financial reporting purposes are generally accounted for under the cost method for tax purposes. Subsequent to the date of acquisition, a basis difference between the book and tax basis of an equity method investment (e.g., recording of undistributed earnings for book purposes) creates a temporary difference for which deferred tax assets or liabilities should be recognized in the financial statements. Income taxes levied against the investor for its share of the investee’s results should be included in the investor’s income tax provision line. See TX 11 for further information.

Example 4-25 illustrates the assignment of a positive basis difference on the date of acquisition when the entire positive basis difference is attributable to one asset. Example 4-26 illustrates the assignment of a negative basis difference on the date of acquisition when the entire negative basis difference is attributable to one asset. For purposes of each example, transaction costs and tax implications are ignored. See Example 4-27 and Example 4-28 for more complex examples that are inclusive of the potential tax accounting implications.

**EXAMPLE 4-25**

**Accounting for a positive basis difference on the date of acquisition**

Investor purchased a 40% interest in the voting common stock of Investee for $56 million, a price reflective of fair value at the acquisition date. Investor determined that it has the ability to exercise significant influence over the operating and financial policies of Investee. Therefore, Investor accounts for its interest in Investee under the equity method.
Investor engaged a third party valuation expert to perform a fair value assessment of Investee’s fixed assets. Using the assistance of a third party valuation expert, Investor determined that the fair value of Investee’s fixed assets was $90 million. Investor also concluded that Investee’s book value of its current assets was representative of fair value. As a result of the difference between the fair and book values of Investee’s fixed assets, the cost of the investment was greater than the Investor’s share of the Investee’s net assets.

At the date of acquisition, Investee’s assets and liabilities are as follows (in millions):

<table>
<thead>
<tr>
<th>Line item</th>
<th>Book value (BV) of Investee</th>
<th>Fair value (FV) of Investee</th>
<th>Investor share of Investee BV</th>
<th>Investor share of Investee FV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>$50</td>
<td>$50</td>
<td>$20</td>
<td>$20</td>
</tr>
<tr>
<td>Fixed assets</td>
<td>50</td>
<td>90</td>
<td>20</td>
<td>36</td>
</tr>
<tr>
<td>Net assets</td>
<td>$100</td>
<td>$140</td>
<td>$40</td>
<td>$56</td>
</tr>
</tbody>
</table>

How should Investor record its investment in Investee on the acquisition date?

**Analysis**

Investor should record its investment in Investee at its cost of $56 million. The difference between the Investor’s share of the net assets measured at (1) fair value ($56 million) and (2) book value ($40 million) of $16 million is entirely attributable to the fixed assets. The positive basis difference would be amortized into income as an increase to depreciation expense in the equity method memo accounts over the useful life of the fixed assets, which would result in a decrease in Investor’s share of equity in earnings of Investee (income statement) and a corresponding decrease in the investment balance (balance sheet).

**EXAMPLE 4-26**

**Accounting for a negative basis difference on the date of acquisition**

Investor purchased a 40% interest in the voting common stock of Investee for $32 million, a price reflective of fair value at the acquisition date. Investor determined that it has the ability to exercise significant influence over the operating and financial policies of Investee. Therefore, Investor accounts for its interest in Investee under the equity method.

Investor performed extensive due diligence of Investee, which included the review of financial statements, review of management forecasts, and inquiries of executive management. During the due diligence process, Investor noted that Investee had performed a long-lived asset impairment test for its fixed assets and determined that the book value of its fixed assets were recoverable under a held and used assumption. Therefore, no impairment charge was recorded by Investee (even though there had likely been a decline in the fair value of the fixed assets to below book value). As a result of the difference between the fair and book values of Investee’s fixed assets, the cost of the investment was less than the Investor’s share of the Investee’s net assets.
At the date of acquisition, Investee’s assets and liabilities are as follows (in millions):

<table>
<thead>
<tr>
<th>Line item</th>
<th>Book value (BV) of Investee</th>
<th>Fair value (FV) of Investee</th>
<th>Investor share of Investee BV</th>
<th>Investor share of Investee FV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>$50</td>
<td>$50</td>
<td>$20</td>
<td>$20</td>
</tr>
<tr>
<td>Fixed assets</td>
<td>50</td>
<td>30</td>
<td>20</td>
<td>12</td>
</tr>
<tr>
<td><strong>Net assets</strong></td>
<td><strong>$100</strong></td>
<td><strong>$80</strong></td>
<td><strong>$40</strong></td>
<td><strong>$32</strong></td>
</tr>
</tbody>
</table>

How should Investor record its investment in Investee on the acquisition date?

**Analysis**

Investor should record its investment in Investee at its cost of $32 million. The difference between the Investor’s share of the net assets measured at (1) fair value ($32 million) and (2) book value ($40 million) of negative $8 million is entirely attributable to the fixed assets. This negative basis difference would be accreted to income as a reduction to depreciation expense in the equity method memo accounts over the life of the fixed assets, which will result in an increase in Investor’s share of equity in earnings of Investee (income statement) and a corresponding increase in the investment balance (balance sheet).

**4.4.5.2 Equity method goodwill**

An investor may not be able to attribute all of the basis difference between the cost of its investment and its share of the carrying value of the net assets of the investee to individual assets and liabilities of the investee. In cases where there is residual excess of consideration paid over the investor’s share of the investee’s net assets, an investor should assign that residual excess to equity method goodwill. An investor cannot arbitrarily assign the entire excess to equity method goodwill. That is, an investor must first make all reasonable efforts to attribute the excess to individual assets and liabilities of the investee before assigning the residual to equity method goodwill. For example, if an investee held a building for which its fair value exceeded its carrying value, it would not be appropriate for an investor to assign the entire excess to equity method goodwill if the cost of the investment clearly reflects the fair value of such appreciated building. The assignment of the appreciation in the building to equity method goodwill would result in the nonamortization of the building’s appreciation, misstating the period-to-period equity in earnings of the investee in the financial statements of the investor, since goodwill is not generally amortized (see CG 4.4.5.6 for consideration of the private company goodwill accounting alternative).

Example 4-27 illustrates the procedures for assigning the difference between the cost of an investment and the underlying equity in net assets, with the residual excess assigned to equity method goodwill.
EXAMPLE 4-27
Assignment of basis differences with residual excess assigned to equity method goodwill

Investor purchased a 25% interest in the voting common stock of Investee for cash consideration of $1,000,000. On the acquisition date, the net assets of Investee, as reflected in its general ledger and determined in accordance with GAAP, were as follows:

<table>
<thead>
<tr>
<th>Line item</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$175,000</td>
</tr>
<tr>
<td>Other net current assets</td>
<td>125,000</td>
</tr>
<tr>
<td>Fixed assets</td>
<td>1,200,000</td>
</tr>
<tr>
<td><strong>Net assets</strong></td>
<td><strong>$1,500,000</strong></td>
</tr>
<tr>
<td>Investor’s 25% share</td>
<td>$375,000</td>
</tr>
</tbody>
</table>

Investor determined the following:

- Investee’s property and plants are modern with current technologies and have a fair value of $2,400,000. The remaining useful life of its fixed assets is estimated to be 20 years.
- Investee holds valuable patents on its technical processes that have a fair value of $250,000 and an estimated technological life of 10 years. Costs associated with developing the processes were fully expensed by Investee.
- Investee has a strong earnings growth record, a relevant consideration for income tax accounting purposes (e.g., realizability of deferred tax assets). Investee’s applicable tax rate is 40%.
- Other net current assets represent raw materials, receivables, and payables. The book values of these items approximate their fair values.

How should Investor account for the basis difference between the cost of its investment and its share of the net assets of the Investee?

*Analysis*

The table below illustrates how Investor would assign the basis difference between the cost of its investment and its share of the net assets of Investee of $625,000 to its share of the identified assets acquired and liabilities assumed based on the facts and circumstances described above.
<table>
<thead>
<tr>
<th>Line item</th>
<th>Book value (BV)</th>
<th>Fair value (FV)</th>
<th>Excess</th>
<th>Investor’s share</th>
<th>Subsequent accounting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$175,000</td>
<td>$175,000</td>
<td>$0</td>
<td>$0</td>
<td>N/A</td>
</tr>
<tr>
<td>Other net current assets</td>
<td>125,000</td>
<td>125,000</td>
<td>0</td>
<td>0</td>
<td>N/A</td>
</tr>
<tr>
<td>Fixed assets</td>
<td>1,200,000</td>
<td>2,400,000</td>
<td>1,200,000</td>
<td>300,000</td>
<td>D</td>
</tr>
<tr>
<td>Patents</td>
<td>0</td>
<td>250,000</td>
<td>250,000</td>
<td>62,500</td>
<td>E</td>
</tr>
<tr>
<td>Deferred tax liability</td>
<td>0</td>
<td>(580,000)</td>
<td>(580,000)</td>
<td>(145,000)</td>
<td>F</td>
</tr>
<tr>
<td>Goodwill</td>
<td>0</td>
<td>1,630,000</td>
<td>1,630,000</td>
<td>407,500</td>
<td>C</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1,500,000</strong></td>
<td><strong>4,000,000</strong></td>
<td><strong>2,500,000</strong></td>
<td><strong>625,000</strong></td>
<td><strong>B</strong></td>
</tr>
</tbody>
</table>

A – The deferred tax liabilities relate to the difference between the underlying fair values and the book values of the investee’s assets and liabilities. The deferred tax liability of $580,000 is calculated as the product of total taxable temporary differences, excluding goodwill ($1,200,000 basis difference of fixed assets + $250,000 basis difference of patents), and the Investee’s applicable tax rate (40%). It is assumed for simplicity that there is not any difference at the date of investment between the investor’s book and tax bases in the investment. If there were such a difference, the deferred tax effects might have to be considered in allocating the investor’s excess cost of its investment. See TX 11 for further information.

B – Investor purchased a 25% interest in the voting common stock for $1,000,000. Therefore, for illustrative purposes, the fair value of 100% of the Investee is assumed to be $4,000,000.

C – Equity method goodwill is calculated as the excess of Investor’s purchase price paid to acquire the investment over the fair value amounts assigned to the identified tangible and intangible assets and liabilities (fair value of Investor’s share of Investee’s net assets).

D – The basis difference attributable to the fixed assets would be amortized into equity in earnings of investee (income) over the 20 year useful life of the fixed assets.

E – The basis difference attributable to the patents (intangible assets) would be amortized into equity in earnings of investee (income) over the 10 year useful life of the patents.

F – The deferred tax liability would be recalculated each year based on remaining temporary differences and enacted tax rates.

G – Equity method goodwill would be subject to impairment testing pursuant to ASC 323-10-35-32. See CG 4.6 for further information.

Investor would record its 25% interest in the voting common stock of Investee at $1,000,000, which is comprised of the sum of its share of (1) the investee’s net assets ($375,000), (2) the net excess of fair value over the carrying value of the identified tangible and intangible assets and liabilities ($217,500), and (3) the residual amounts recorded as goodwill ($407,500).
4.4.5.3 **Residual excess of investor’s share of investee’s net assets over cost of investment (excess of fair value of acquired net assets over cost)**

In cases where there is residual excess of the investor’s share of the investee’s net assets over consideration paid (i.e., investor’s share of the fair value of investee’s net assets acquired is greater than cost of investment), an investor should not recognize a bargain purchase gain, as it would in a business combination accounted for pursuant to ASC 805. Unlike in a business combination where an investor obtains control, an investor in an equity method investment does not control the underlying assets of the investee. Therefore, the investor would not be able to realize a gain by selling the underlying assets of the investee. In addition, ASC 323 requires an investor to record an equity method investment based on the accumulated cost of acquiring the investment, not on a fair value basis.

An investor should allocate the residual excess of the investor’s share of the investee’s net assets over consideration paid as a pro-rata reduction (on a fair value basis) of the amounts that otherwise would have been assigned generally to the acquired noncurrent assets. This treatment of the residual excess is consistent with the asset acquisition guidance in ASC 805-50.

Example 4-28 illustrates the procedures for allocating, as a pro rata reduction, the residual excess of an investor’s share of the fair value of the investee’s net assets over consideration paid to the acquired noncurrent assets.

**EXAMPLE 4-28**

**Assignment of basis differences with residual excess allocated as a pro rata reduction of the amounts that otherwise would have been recorded**

Investor purchased a 25% interest in the voting common stock of Investee for cash consideration of $1,000,000. Investee’s tax rate is 40%. On the acquisition date, Investor’s share of the net assets of Investee on a book and fair value basis are as follows:

<table>
<thead>
<tr>
<th>Line item</th>
<th>Book value</th>
<th>Fair value</th>
<th>Investors share book value</th>
<th>Investor’s share preliminary fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$800,000</td>
<td>$800,000</td>
<td>$200,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>1,000,000</td>
<td>1,000,000</td>
<td>$250,000</td>
<td>$250,000</td>
</tr>
<tr>
<td>Fixed assets</td>
<td>2,000,000</td>
<td>3,700,000</td>
<td>$500,000</td>
<td>925,000</td>
</tr>
<tr>
<td>Patent (noncurrent)</td>
<td>0</td>
<td>200,000</td>
<td>0</td>
<td>50,000</td>
</tr>
<tr>
<td>Deferred tax liability</td>
<td>0</td>
<td>-760,000</td>
<td>0</td>
<td>-190,000</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>-800,000</td>
<td>-800,000</td>
<td>-200,000</td>
<td>-200,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>3,000,000</strong></td>
<td><strong>4,140,000</strong></td>
<td><strong>750,000</strong></td>
<td><strong>1,035,000</strong></td>
</tr>
</tbody>
</table>

**A** – Investor concluded that Investee’s book value was representative of fair value.

**B** – Investor determined that its share of the fair value of Investee’s fixed assets was $925,000 and the remaining useful life was estimated to be 20 years.
C – Investor determined that its share of the fair value of Investee’s patent was $50,000 and the remaining useful life was estimated to be 10 years.

D – The preliminary deferred tax liability ($190,000) is calculated as the product of total taxable temporary differences, excluding goodwill ($425,000 basis difference of fixed assets + $50,000 basis difference of patent), and the Investee’s applicable tax rate (40%). It is assumed for simplicity that there is not any difference at the date of investment between the investor’s book and tax bases in the investment. If there were such a difference, the deferred tax effects might have to be considered in allocating the investor’s excess cost of its investment. See TX 11 for further information.

E – Investor’s proportionate share of the fair value of Investee’s net assets of $1,035,000 exceeds the cost of its investment of $1,000,000, resulting in residual excess of $35,000.

How should Investor account for the basis difference between the cost of the investment and its share of the Investee’s net assets?

**Analysis**

Investor should not recognize a bargain purchase gain of $35,000 for the residual excess on its acquisition of a 25% interest in Investee. Rather, Investor should allocate the residual excess of $35,000 as a pro-rata reduction of the preliminary fair value amounts assigned to the fixed assets and patent and related deferred tax effects utilizing an iterative calculation. After performing such iterative calculation, which can be accomplished through use of basic software, the final fair value of Investor’s proportionate share of the Investee’s net assets, including the deferred tax liability, should equal Investor’s cost of the investment.

<table>
<thead>
<tr>
<th>Line item</th>
<th>Book value</th>
<th>Preliminary fair value</th>
<th>Final fair value</th>
<th>Basis difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$200,000</td>
<td>$200,000</td>
<td>$200,000</td>
<td>$0</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>250,000</td>
<td>250,000</td>
<td>250,000</td>
<td>0</td>
</tr>
<tr>
<td>Fixed assets</td>
<td>500,000</td>
<td>925,000</td>
<td>869,658</td>
<td>369,658</td>
</tr>
<tr>
<td>Patent (noncurrent)</td>
<td>0</td>
<td>50,000</td>
<td>47,009</td>
<td>47,009</td>
</tr>
<tr>
<td>Deferred tax liability</td>
<td>0</td>
<td>(190,000)</td>
<td>(166,667)</td>
<td>(166,667)</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>(200,000)</td>
<td>(200,000)</td>
<td>(200,000)</td>
<td>0</td>
</tr>
<tr>
<td><strong>Share of net assets</strong></td>
<td><strong>$750,000</strong></td>
<td><strong>$1,035,000</strong></td>
<td><strong>$1,000,000</strong></td>
<td><strong>$250,000</strong></td>
</tr>
</tbody>
</table>

Investor should assign the adjusted basis differences of $369,658 and $47,009 to the acquired fixed assets and patent, respectively, within the equity method accounting records. Investor would recognize annual amortization expense of $23,184 ($369,658/20 +(47,009/10)), adjusted for deferred taxes, as a reduction to its equity in earnings (income statement) and investment in Investee (balance sheet).

An investor, through its ability to exercise significant influence over the investee, will generally be able to obtain sufficient financial data to determine the primary assets and liabilities giving rise to a basis difference. In the unusual circumstance where an investor is unable to do so, the inability to obtain
such information from the investee must be reconciled with the conclusion that the investor has the
ability to exercise significant influence over the operating and financial policies of the investee.

4.4.5.4  Accounting considerations for investee deferred taxes (equity method)

An investee’s financial statements will already reflect any deferred tax assets and liabilities for
temporary differences between the carrying values of its assets and liabilities and their associated tax
bases. These basis differences are inside basis differences of the investee and do not require additional
accounting by an investor.

An investee may have a substantial deferred tax asset for which a partial or full valuation reserve has
been recorded based on the investee’s conclusion that it is not more likely than not that the net
operating losses will be realized. In some cases, an investor may be willing to pay a premium to obtain
an interest in that investee based on its view that a net deferred tax asset has value in excess of the
amount recorded in the investee’s financial statements. However, in these cases, an investor is
precluded from assigning any of the premium paid to the investee’s deferred tax assets in its equity
method memo accounts because the investor’s investment in the investee does not (1) result in a
change in control (at the investee level) and (2) provide the investee with a new ability to recover the
deferred tax assets for which partial or full valuation allowances is recorded.

Example 4-29 illustrates an investor’s accounting for the excess of the cost of the investor’s share of
investee net assets when a premium is attributable to unrecognized tax benefits of the investee.

EXAMPLE 4-29

Accounting for the excess of cost over the investor’s share of investee net assets when a premium is
attributable to unrecognized tax benefits of the investee

Investee is a public company that has a substantial deferred tax asset related to net operating loss
(NOL) carryforwards. Investee has a full valuation allowance recorded against the deferred tax asset
because of losses in recent years. Investee is currently traded at a premium compared to its net assets,
which has been attributed to a belief by investors that Investee will eventually be able to employ a
strategy to utilize its NOL carryforwards.

Investor acquired a 20% ownership interest in the voting common stock of Investee and determined
that it should account for the investment under the equity method of accounting. At the date on which
Investor acquires its 20% interest in Investee at market price, its cost exceeds its proportionate share
of the carrying amount of the net assets of Investee by approximately $500,000. For simplicity,
assume there are no unrecognized intangible assets or liabilities and no other recognized assets or
liabilities of Investee to which the premium paid by Investor should be attributed.

Should any portion of the $500,000 premium paid by Investor be assigned to the deferred taxes
related to NOL carryforwards?

Analysis

No. As discussed in CG 4.4.5, the difference, at the date of investment, between the cost of the
investment and the underlying equity in net assets, should be accounted for according to its nature. In
accounting for potential basis differences related to deferred tax assets, Investor should consider the
business combinations guidance in ASC 805-740-25-2, which refers to ASC 740-10, Income Taxes, for
the accounting for acquired deferred tax balances. Investee has concluded that it is not more likely than not that the NOL carryforwards will be realized. Therefore, Investee recorded a full valuation allowance.

Because there has been no change in control as a result of Investor’s investment and the Investor’s investment does not provide Investee with any new ability to recover the deferred tax assets, Investor would not assign any book value to the deferred tax assets when assigning the premium paid to acquire the investment. Because there were no unrecognized intangible assets or liabilities and no other recognized assets or liabilities of Investee to which the premium paid by Investor should be attributed, the $500,000 premium of cost over fair value should be considered goodwill in Investor’s equity method memo accounts.

Prospectively, Investor will need to analyze the goodwill for impairment in accordance with the provisions of ASC 323-10-35-32. See CG 4.6 for further information.

4.4.5.5 Accumulated other comprehensive income – basis differences (equity method)

An investee may hold assets or liabilities whose changes in value are reported in accumulated other comprehensive income (AOCI) pursuant to other GAAP. For example, an investee may have investments in available-for-sale securities accounted for pursuant to ASC 320, derivative financial instruments accounted for pursuant to ASC 815, Derivatives and Hedging (e.g., derivative financial instrument designated as a cash flow hedge), and/or pension or post-employment benefits accounted for pursuant to ASC 715, Compensation—Retirement Benefits.

At the date on which it obtains an investment that is to be accounted for under the equity method of accounting, an investor must identify and measure all of the investee’s identifiable assets and liabilities at their acquisition date fair values. For those assets and liabilities whose changes in value are reported in AOCI, the investor will not recognize its proportionate share of the amounts previously reported in the investee’s AOCI balance (i.e., the investor would record those assets and liabilities at fair value; therefore, there are no unrealized amounts to report in AOCI in the investor’s accounts). The amounts reported in the investee’s AOCI balance create additional basis differences that must be tracked by the investor within the equity method memo accounts in order to ensure that the investor does not recognize such amounts when they are reclassified to earnings in the investee’s financial statements.

Example 4-30 illustrates an investor’s accounting for the investee’s AOCI at date of acquisition and upon sale.

**EXAMPLE 4-30**
Investor’s accounting for investee’s AOCI at date of acquisition and upon sale

Investor acquired a 20% interest in the voting common stock of Investee that will be accounted for under the equity method of accounting. Investee holds an available-for-sale debt security that it purchased for $100. The fair value of the available-for-sale debt security at the investment date is $150; therefore, investee reported $50 in unrealized gains in AOCI. One year later, Investee sells the available-for-sale security for $150.

How should Investor account for its proportionate share of Investee’s available-for-sale debt security at the investment date and upon Investee’s sale of the available-for-sale security?
Analysis

At the acquisition date, Investor would recognize its proportionate share of the fair value of the available-for-sale debt security of $30 ($150 * 20%).

Upon sale for $150, Investee would recognize a realized gain of $50; however, Investor would not record its proportionate share of Investee’s realized gain because its basis in the Investee’s available-for-sale debt security would already reflect the security’s appreciation. Therefore, Investor would reduce its equity in earnings of Investee by $10 ($50 * 20%).

4.4.5.6 Private company goodwill accounting alternative (equity method)

A company that adopts the private company goodwill accounting alternative (“goodwill alternative”) approved by the Private Company Council (“PCC”) and endorsed by the FASB should account for equity method goodwill in the same manner in which it accounts for goodwill recognized in connection with a business combination.

A private company that recognizes equity method goodwill in connection with an equity method investment in an investee and adopts the goodwill alternative should amortize such goodwill on a straight-line basis over 10 years, or less than 10 years if the entity demonstrates that another useful life is more appropriate, in accordance with ASC 323-10-35-13. See BCG 9.12 for further information regarding the goodwill alternative.

When calculating its proportionate share of the equity in earnings of the investee, a public company investor must eliminate the effects of a private company investee’s adoption of the goodwill alternative as the goodwill alternative is not available to public companies. See further discussion at CG 4.5.6.4.

4.4.5.7 Conforming investee financial statements to US GAAP (equity method)

When an investee’s financial statements are prepared on a basis other than US GAAP, the investor that follows US GAAP must eliminate material variances to convert the investee’s financial statements to US GAAP prior to determining the difference between the cost of its investment and its share of the underlying equity in the investee’s net assets. Variances from US GAAP must be accounted for on a continuing basis, similar to the required accounting for basis differences discussed in CG 4.4.5. See CG 4.5.6 for further discussion of adjustments for the application of different accounting principles by the investee.

4.4.6 Investment becomes qualified for the equity method

An investor holding an investment may increase its ownership interest in the common stock or in-substance common stock of an investee to a level of ownership that provides the investor with the ability to exercise significant influence over the operating and financial policies of the investee. In these cases, an investor should adopt the equity method of accounting and apply it prospectively from the date significant influence is obtained. An investor should add the cost of acquiring the additional interest in the investee (if any) to the current basis of its previously held interest.

ASC 323 does not provide specific guidance on how any basis differences should be determined and allocated to the equity method investment in these cases. We believe there are several reasonable and acceptable methods in determining and allocating any basis differences. For example, assume an
An investor’s acquisition price paid to acquire an interest in an investee may exceed its share of the underlying equity in net assets due to in-process research and development (“IPR&D”) of the investee. If the investee is not a business (i.e., an asset acquisition), as defined in ASC 805, the investor should immediately recognize a charge to expense for acquired IPR&D if the IPR&D does not have an alternative future use (see 805-50-35-1). If the investee qualifies as a business, the investor should record an intangible asset to capitalize the IPR&D in its equity method accounting records, regardless of whether it has an alternative future use, as if the investee were a consolidated subsidiary pursuant to the guidance in ASC 323-10-35-13. See BCG 4.3.4.1 for further information on the accounting for purchased IPR&D.

4.5 Subsequent accounting for equity method investments

The subsequent accounting for an equity method investment generally follows the consolidation model. An investor records its share of the investee’s earnings and investee distributions, records intercompany elimination adjustments, and records other adjustments as described in this section.

4.5.1 Share of earnings of the investee (equity method)

Whether the initial investment is recorded at cost or fair value, the investor recognizes through net income and as an adjustment to the investment balance, its proportionate share of the reported earnings or losses of the investee, adjusted to reflect other items discussed below. For example, adjustments to an investor’s proportionate share of the reported earnings of losses of the investee may be necessary as a result of such items as the amortization of basis differences (see CG 4.5.5.1) or the elimination of intra-entity (intercompany) gains or losses (see CG 4.5.2).

The investor’s share of investee earnings or losses is generally based on shares of common stock or in-substance common stock held by the investor. However, there may also be other investments that participate in earnings. For example, an investor may need to record earnings on an investment in investee’s preferred stock; however, the investor usually does not recognize earnings or losses for potential common shares, such as those that might arise due the exercise of options or warrants.

Determining the investor’s share of the earnings or losses of the investee may be straightforward when all income and distributions (including distributions in liquidation) are determined based on interests held or a fixed percentage allocated to each equity holder. However, the allocation becomes more complex when the investee has multiple classes of equity outstanding or the allocation of earnings or cash distributions to investors is not commensurate with ownership interests.

When the investee has multiple classes of common stock outstanding, careful analysis is required to determine if a single class is subordinate or if all classes possess substantially identical subordination characteristics to determine the investor’s share of the investee’s earnings or losses.
4.5.1.1  Preferred stock impact on share of earnings of the investee (equity method)

An investor would not adjust its share of the investee’s earnings or losses for any non-cumulative preferred dividends unless those dividends were declared. For cumulative preferred dividends, an investor generally determines its share of the earnings or losses of the investee after deducting the investee’s cumulative preferred dividends, irrespective of whether those dividends have been declared. However, depending on individual facts and circumstances, that may not always be appropriate.

In particular, sometimes preferred dividends are only cumulative when earned, i.e., to the extent that sufficient income is generated by the investee. The preferred shareholders then have no future claim arising from dividends for which sufficient income has not been generated. In that case, the investee income (loss) is only adjusted to the extent preferred dividends are earned.

If the preferred shareholders are entitled to payment of the unpaid dividends (even though not earned) prior to the declaration of common stock dividends or as a preference upon liquidation, then the dividends should be deducted from investee income or added to investee losses prior to determining the investor’s share of those earnings or losses.

Accretion of mandatorily redeemable preferred stock is required when the stock is redeemable at a fixed or determinable date, or at any time at the holder’s option. The investor in common shares should compute its share of earnings (or losses) of the investee after reducing those earnings (or increasing those losses) for the accretion of mandatorily redeemable preferred stock issued by the investee. If the investor holds shares of the mandatorily redeemable preferred stock, its accounting would be impacted.

4.5.1.2  Varying profit allocations (equity method)

When investment agreements include different allocations among the investors for the investee’s earnings and its taxable profit and loss, distributions of cash from operations, and/or distributions of cash proceeds on liquidation, additional complexities arise when determining how to record the investee earnings for book purposes. Care should be taken in determining the method used to allocate profits among the investors for GAAP accounting purposes. When determining the appropriate share of investee equity earnings to be allocated to the investors, all pertinent agreements among the investors should be carefully evaluated to determine the rights of the investors. ASC 970, Real Estate, contains guidance on the allocation of investee earnings for investments in real estate ventures; however, in practice, this guidance is also considered when determining an investor’s share of an investee’s earnings for investments in non-real estate ventures.
Excerpt from ASC 970-323-35-17

Such agreements may also provide for changes in the allocations at specified times or on the occurrence of specified events. Accounting by the investors for their equity in the venture’s earnings under such agreements requires careful consideration of substance over form and consideration of underlying values as discussed in paragraph 970-323-35-10. To determine the investor’s share of venture net income or loss, such agreements or arrangements shall be analyzed to determine how an increase or decrease in net assets of the venture (determined in conformity with GAAP) will affect cash payments to the investor over the life of the venture and on its liquidation. Specified profit and loss allocation ratios shall not be used to determine an investor’s equity in venture earnings if the allocation of cash distributions and liquidating distributions are determined on some other basis.

Consideration should be given to the possibility that the allocation of profit and loss specified in the investee’s governing agreements may be solely for tax purposes, or that it may have a different economic purpose throughout the life of the partnership and in liquidation. The specified profit allocation should be followed for GAAP purposes only when cash distributions in liquidation are based on the balances in the investors’ capital accounts after all previous profits and losses have been recorded following the specified profit allocation. When substantive, the specified profit allocation should retain its outcome over time and not be reversed in or prior to liquidation based on subsequent events.

The profit allocation specified in the agreements generally is not used for GAAP purposes when the allocation of cash distributions, both from operations and in liquidation, is determined on some basis other than ownership percentages. A common example of this situation occurs in a structure where the initial investment by the investors and the subsequent allocation of earnings differ to enable certain investors to obtain the tax benefits. Another example may be a manager or developer who owns all of one class of shares, while one or more investors own all of a different class of shares. In these situations, it may not be appropriate for an investor to record a straight percentage of the entity’s earnings if the rights and economics of the shares are different.

Similarly, if the investors’ ownership percentages or rights to distributions change after a period of time, it may not be appropriate for an investor to calculate the allocation based on the applicable percentages in the different time periods. For example, if per the investment agreement, an investor is entitled to 80% of the profit allocation during the first five years and 20% thereafter, it may not be appropriate to follow this allocation in recording its share of equity investee earnings. When the profit allocation will ultimately be reflected in cash payouts upon liquidation, the earnings determined to accrue to the investor may have to be reduced to some estimate of present value when the investor must await liquidation at some indefinite future time.

These different profit allocation arrangements most frequently occur in real estate, or other tax motivated situations where the investor (often a limited partner) recoups its investment through a combination of positive cash flow and reduced tax payments from losses reported for income tax purposes. Many times, such arrangements are partnerships for tax purposes, and distributable shares of taxable profit and loss are reported by the individual investors. The investor’s share of the investee earnings or losses must be determined on a pretax basis.

One way to apply the equity method in these circumstances is referred to as the hypothetical liquidation at book value, or HLBV, method, which is discussed in ASC 323-10-35-27 to 35-28 and 35-
The HLBV method may be helpful in dealing with some of the complex structures found in practice.

**4.5.1.3 Hypothetical liquidation at book value method (equity method)**

The hypothetical liquidation at book value (HLBV) method applies the equity method of accounting based on changes in the investor’s claim on the net assets of the investee. The manner of applying the HLBV method varies depending on the agreements and the reporting entity’s accounting policies.

The HLBV method is not necessarily an accounting principle or an accounting policy election. Rather, it is a mechanical approach that calculates the earnings an investor should recognize based on how an entity would allocate and distribute its cash if it were to sell all of its assets and settle its liabilities for their carrying amounts and liquidate at a particular point in time. This approach to the equity method is commonly referred to as a balance sheet approach.

Under the HLBV method, an investor calculates its claim on the investee’s assets at the beginning and end of the reporting period, using the carrying value of the investee’s net assets as reported under US GAAP at those reporting dates, and then considers the contractual liquidation waterfall (i.e., the amount the investee would distribute if it were to liquidate all of its net assets and allocate the cash to its investors based on its articles of incorporation, bylaws, or other governing documents). Current period earnings would be recognized by the investor based on the change in its claim on net assets of the investee, excluding any contributions received or distributions made by the investee during the period. The HLBV approach is based on the contractual liquidation waterfall assuming liquidation at book value at the balance sheet date.

In some cases, the liquidation waterfall will not reflect the actual distributions expected if the entity continues as a going concern. For example, this would be the case if the allocations in operations were substantially different than those in liquidation. Similarly, a liquidation assumption may not be appropriate if the profit allocation percentages change among the investors based only on the passage of time and certain assets (e.g., deferred tax balances) will be recognized in specific periods.

Reporting entities should consider whether the liquidation waterfall appropriately reflects the entity’s economics prior to application of the HLBV method. As illustrated above, in some situations, it may be necessary to factor in other considerations to appropriately reflect the investor’s actual interest in the investee’s assets.

In practice, liquidation waterfalls are often complex and reporting entities should carefully evaluate all pertinent agreements to determine the proper income allocation. In addition, these agreements are often developed with a focus on income tax regulations. Therefore, performing the evaluation with the assistance of tax experts may be helpful.

The following example from ASC 323 is reproduced to only include Case B therein which illustrates the approach to determining the amount of equity method earnings based on the change in the investor’s claim on the investee’s book value. While not specifically referred to as HLBV, this example illustrates some of the same concepts.
Excerpt from ASC 323-10-55-49

a. Investee was formed on January 1, 20X0.

b. Five investors each made investments in and loans to Investee on that date and there have not been any changes in those investment levels (that is, no new money, reacquisition of interests by Investee, principal payments by Investee, or dividends) during the period from January 1, 20X0 through December 31, 20X3.

c. Investor A owns 40 percent of the outstanding common stock of Investee; the common stock investment has been reduced to zero at the beginning of 20X1 because of previous losses.

d. Investor A also has invested $100 in preferred stock of Investee (50 percent of the outstanding preferred stock of Investee) and has extended $100 in loans to Investee (which represents 60 percent of all loans extended to Investee).

e. Investor A is not obligated to provide any additional funding to Investee. As of the beginning of 20X1, the adjusted basis of Investor's total combined investment in Investee is $200, as follows:

<table>
<thead>
<tr>
<th>Investment</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock</td>
<td>—</td>
</tr>
<tr>
<td>Preferred stock</td>
<td>100</td>
</tr>
<tr>
<td>Loan</td>
<td>100</td>
</tr>
</tbody>
</table>

f. Investee operating income (loss) from 20X1 through 20X3 is as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Income/Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X1</td>
<td>($160)</td>
</tr>
<tr>
<td>20X2</td>
<td>($200)</td>
</tr>
<tr>
<td>20X3</td>
<td>$500</td>
</tr>
</tbody>
</table>

g. Investee’s balance sheet is as follows:

<table>
<thead>
<tr>
<th></th>
<th>1/1/X1</th>
<th>12/31/X1</th>
<th>12/31/X2</th>
<th>12/31/X3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>$367</td>
<td>$207</td>
<td>$7</td>
<td>$507</td>
</tr>
<tr>
<td>Loan</td>
<td>167</td>
<td>167</td>
<td>167</td>
<td>167</td>
</tr>
<tr>
<td>Preferred stock</td>
<td>200</td>
<td>200</td>
<td>200</td>
<td>200</td>
</tr>
<tr>
<td>Common stock</td>
<td>300</td>
<td>300</td>
<td>300</td>
<td>300</td>
</tr>
<tr>
<td>Accumulated deficit</td>
<td>(300)</td>
<td>(460)</td>
<td>(660)</td>
<td>(160)</td>
</tr>
<tr>
<td></td>
<td>$367</td>
<td>$207</td>
<td>$7</td>
<td>$507</td>
</tr>
</tbody>
</table>

ASC 323-10-55-54

Under this approach, Investor A would recognize equity method losses based on the change in the investor’s claim on the investee’s book value.
Equity method of accounting

**ASC 323-10-55-55**

With respect to 20X1, if Investee hypothetically liquidated its assets and liabilities at book value at December 31, 20X1, it would have $207 available to distribute. Investor A would receive $120 (Investor A’s 60% share of a priority claim from the loan [$100] and a priority distribution of its preferred stock investment of $20 [which is 50% of the $40 remaining to distribute after the creditors are paid]). Investor A’s claim on Investee’s book value at January 1, 20X1, was $200 (60% × $167 = $100 and 50% × $200 = $100). Therefore, during 20X1, Investor A’s claim on Investee’s book value decreased by $80 and that is the amount Investor A would recognize in 20X1 as its share of Investee’s losses. Investor A would record the following journal entry.

| Equity method loss          | $80 |
| Preferred stock investment | 80  |

**ASC 323-10-55-56**

With respect to 20X2, if Investee hypothetically liquidated its assets and liabilities at book value at December 31, 20X2, it would have $7 available to distribute. Investor A would receive $4 (Investor A’s 60% share of a priority claim from the loan). Investor A’s claim on Investee’s book value at December 31, 20X1, was $120 (see the preceding paragraph). Therefore, during 20X2, Investor A’s claim on Investee’s book value decreased by $116 and that is the amount Investor A would recognize in 20X2 as its share of Investee’s losses. Investor A would record the following journal entry.

| Equity method loss          | $116 |
| Preferred stock investment | 20   |
| Loan                        | 96   |

**ASC 323-10-55-57**

With respect to 20X3, if Investee hypothetically liquidated its assets and liabilities at book value at December 31, 20X3, it would have $507 available to distribute. Investor A would receive $256 (Investor A’s 60% share of a priority claim from the loan [$100], Investor A’s 50% share of a priority distribution from its preferred stock investment [$100], and 40% of the remaining cash available to distribute [$140 × 40% = $56]). Investor A’s claim on Investee’s book value at December 31, 20X2, was $4 (see above). Therefore, during 20X3, Investor A’s claim on Investee’s book value increased by $252 and that is the amount Investor A would recognize in 20X3 as its share of Investee’s earnings. Investor A would record the following journal entry.

| Loan                        | 96   |
| Preferred stock             | 100  |
| Investment in investee      | 56   |
| Equity method income        | 252  |

**4.5.2 Elimination of intercompany transactions (equity method)**

An investor applying the equity method may need to make adjustments to eliminate the effects of certain intercompany transactions. While ASC 323 refers to the consolidation guidance under ASC 810 for guidance on eliminations, the extent of the eliminations under the equity method are more limited than are required when consolidating a subsidiary.
Equity method of accounting

**ASC 323-10-35-7**

Intra-entity profits and losses shall be eliminated until realized by the investor or investee as if the investee were consolidated. Specifically, intra-entity profits or losses on assets still remaining with an investor or investee shall be eliminated, giving effect to any income taxes on the intra-entity transactions, except for any of the following:

a. A transaction with an investee (including a joint venture investee) that is accounted for as a deconsolidation of a subsidiary or a derecognition of a group of assets in accordance with paragraphs 810-10-40-3A through 40-5.

b. A transaction with an investee (including a joint venture investee) that is accounted for as a change in ownership transaction in accordance with paragraphs 810-10-45-21A through 45-24.

c. A transaction with an investee (including a joint venture investee) that is accounted for as the derecognition of an asset in accordance with Subtopic 610-20 on gains and losses from the derecognition of nonfinancial assets.

As eliminations are only made for unrealized profits or losses, the first step to determine if any eliminations are needed is to identify if any intercompany asset remains on the books of either the investor or investee for which the earnings process is not complete. For example, if an investor sells inventory to the investee and that inventory remains on the books of the investee at the reporting date, then the unrealized profit or loss should generally be eliminated. Once the inventory is sold by the investee to a third party, any previously eliminated intercompany profit is recognized.

Under ASC 810, a parent and its consolidated subsidiaries are presented as a single economic unit and transactions between entities within that unit are eliminated in full. However, despite the equity method being viewed as a form of consolidation, albeit in one-line, the financial statements of the investor do not purport to reflect the investor and equity method investee as a single economic entity.

**ASC 323-10-35-8**

Because the equity method is a one-line consolidation, the details reported in the investor’s financial statements under the equity method will not be the same as would be reported in consolidated financial statements under Subtopic 810-10. All intra-entity transactions are eliminated in consolidation under that Subtopic, but under the equity method, intra-entity profits or losses are normally eliminated only on assets still remaining on the books of an investor or an investee.

The difference in the approach to eliminations between consolidation and the equity method is illustrated in Example 4-31.

**EXAMPLE 4-31**

Differences in recording intercompany eliminations

Investor has a 40% ownership interest in Investee. Investee provides outsourcing services to a number of customers, including Investor. Investee earns a fee for these services. During the current year, Investee charged Investor $5 million for providing outsourcing services. Investee made an operating profit for the year of $2 million for the services it provided to Investor. For purposes of this example,
all other operations of Investee are assumed to be break-even (i.e., total Investee operating profit for the year is $2 million) and tax implications have been ignored.

What intercompany eliminations should Investor record when Investor (1) consolidates Investee or (2) accounts for its investment in Investee under the equity method of accounting?

**Analysis**

If Investor consolidates Investee, it would eliminate the $5 million fee in the consolidated financial statements by reducing revenue (the $5 million recorded by Investee) against operating expenses (the $5 million outsourcing fee expense recorded by Investor). As Investor and Investee are reflected as a single economic entity, all of Investee’s expenses to provide outsourcing services and the revenue earned from services to external customers would be reflected in the consolidated accounts.

However, if Investor accounts for Investee under the equity method, no elimination would occur since there is no asset remaining on the books of Investor or Investee. Even if a receivable for the fee remained on the books of Investee, and a payable on the books of Investor, the earnings process is considered complete. Investor would reflect its share of earnings from Investee in a single line item as $800,000 (total Investee earnings of $2 million × 40%) and a separate operating expense of $5 million for the outsourcing services.

Another example illustrating the difference in elimination principles between consolidation and the equity method is when an investor leases an item to an investee under an operating lease arrangement. The investor would normally earn the rental income and the investee would normally expense the rental amount in the same period, and no elimination is needed on the basis that the earnings process is complete. In contrast, if the investor consolidated the investee, all rental income earned by the investor and all rental expense incurred by the investee would be eliminated in the consolidated financial statements.

**4.5.2.1 Determining gains or losses to be eliminated (equity method)**

ASC 323-10-35-9 states that the relationship between the investor and investee will determine whether or not all or a portion of unrealized profits should be eliminated.

Generally, the investor only eliminates profit in relation to the investor’s ownership interest in the investee. The percentage of profit to be eliminated is the same regardless of whether it is in relation to downstream transactions (sales by the investor to the investee) or upstream transactions (sales by the investee to the investor). Profit earned by the investor should be eliminated until it is realized. Such profits would generally be considered realized when the asset has been sold through to third parties (e.g., inventory sold by an investor to an investee is sold to a third party).

In certain circumstances, it may be appropriate for profits to be entirely eliminated. One example given in the consolidation guidance is when the investor controls the investee through majority voting interest (or through guarantees of indebtedness, extension of credit, etc.) and enters into a transaction with the investee that is not at arm’s-length. In such a case, complete elimination of the intra-entity (intercompany) income is required until it has been realized through sale to third parties. While this example is written in the context of consolidation, this concept would also be relevant under the equity method.
In general, eliminating some or all of the unrealized profit is required, even in situations where there may appear to be an arm’s-length transaction between independent entities. Pre-affiliation profits between the investor and investee, such as when inventories or other assets were sold by one company to another prior to their affiliation, should generally not be eliminated.

The following two examples in the guidance illustrate the elimination by an investor of its portion of profits in a downstream and upstream transaction. For the purposes of these examples, the investor has a 30% interest and both the investor and investee have a 40% income tax rate.

**ASC 323-10-55-28**

**Case A: Investor Sells Inventory Downstream to Investee**

Assume an investor sells inventory items to the investee (downstream). At the investee’s balance sheet date, the investee holds inventory for which the investor has recorded a gross profit of $100,000. The investor’s net income would be reduced $18,000 to reflect a $30,000 reduction in gross profit and a $12,000 reduction in income tax expense. The elimination of intra-entity profit might be reflected in the investor’s balance sheet in various ways. The income statement and balance sheet presentations will depend on what is the most meaningful in the circumstances.

**ASC 323-10-55-29**

**Case B: Investee Sells Inventory Upstream to Investor**

Assume an investee sells inventory items to the investor (upstream). At the investor’s balance sheet date, the investor holds inventory for which the investee has recorded a gross profit of $100,000. In computing the investor’s equity pickup, $60,000 ($100,000 less 40 percent of income tax) would be deducted from the investee’s net income and $18,000 (the investor’s share of the intra-entity gross profit after income tax) would thereby be eliminated from the investor’s equity income. Usually, the investor’s investment account would also reflect the $18,000 intra-entity profit elimination, but the elimination might also be reflected in various other ways; for example, the investor’s inventory might be reduced $18,000.

See CG 4.5.2.2 for information related to the presentation of the effects of intercompany profit in the financial statements.

### 4.5.2.2  
**Effects of intercompany profit on financial statement presentation (equity method)**

As noted in ASC 323-10-55-28, the manner of presenting the effects of intercompany profit in the income statement and balance sheet will depend on what is the most meaningful in the circumstances. A number of alternative methods of presentation may be acceptable. Figure 4-2 details the general and alternative presentations in the context of a sale of inventory. The prohibition on the immediate recognition of the current and deferred income tax impacts of the sale only applies to intercompany inventory transactions. The presentation concepts (other than income tax accounting) also apply to other types of transactions (e.g., sales of fixed assets). The general approach outlined in Figure 4-2 is an acceptable presentation method for both sales by an investor to an investee and sales by an investee to an investor. Among the alternatives outlined in Figure 4-2, in each case, Approach 1 resembles a consolidation model, may be most reflective of the economics, and may be conceptually the most appropriate presentation method.
Investor debits equity in income of the investee and credits the investment account on a net-of-tax basis.

This is acceptable because the elimination of unrealized profit arises as a result of the investor’s ownership interest in the investee and, accordingly, it is considered acceptable to deduct the elimination of profit in determining the investor’s share of investee earnings. The investor recognizes its share of investee earnings only to the extent that it exceeds the unrealized profit on transactions with the investee. This approach also has the advantage of simplifying the reconciliation of movements in the investment account. A net-of-tax basis of elimination is considered acceptable because the presentation of equity in income of the investee under the equity method is normally on a single line, net-of-tax basis in the income statement of the investor.

### Alternative approaches when investor sells (downstream) to investee

<table>
<thead>
<tr>
<th>Approach</th>
<th>Details</th>
</tr>
</thead>
</table>
| **Approach 1** | Debit cost of sales and credit the investment account for the pretax amount of the intra-entity (intercompany) income elimination.  
Credit a deferred income tax provision in the income statement and debit a deferred income tax benefit in the balance sheet. |
| **Approach 2** | Debit cost of sales and credit deferred income (unrealized profit) for the pretax amount.  
Credit a deferred income tax provision in the income statement and debit a deferred income tax benefit in the balance sheet. |
| **Approach 3** | Debit equity in income of the investee for the net-of-tax amount and a deferred income tax benefit account for the amount of the tax benefit and credit a deferred income (unrealized profit) account in the balance sheet. |

### Alternative approaches when investee sells (upstream) to investor

<table>
<thead>
<tr>
<th>Approach</th>
<th>Details</th>
</tr>
</thead>
</table>
| **Approach 1** | Debit equity in income of the investee for the net-of-tax amount, credit inventories for the gross amount of the elimination, and debit the investment account for the amount of the tax benefit.  
When inventory has been acquired from a “cost company” (a joint venture formed to serve as a source of supply in which the |
venturers agree to take production of the investee proportionate to their respective interests; this is substantially a cost-sharing arrangement, the purpose of the intra-entity (intercompany) income elimination is to reduce inventory cost to that of the investee. In the “cost company” situation, this is the only acceptable method.

**Approach 2**

Debit equity in income of the investee and credit inventories for the net-of-tax amount.

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**Unrealized profits to be eliminated exceeds the carrying amount**

Unrealized profits or losses on intercompany transactions should be eliminated, even if the investor’s share of the unrealized profit to be eliminated exceeds the carrying amount of the equity method investment and would reduce the investor's equity method investment balance below zero. In such instances, it may be acceptable to credit the investor’s inventory or fixed asset balances, as appropriate.

**4.5.3 Losses in excess of the carrying amount of the investment (equity method)**

An investor’s share of losses of an investee (including any impairments of its investment as discussed in CG 4.6) may exceed the carrying amount of its investment (including unsecured or subordinated intercompany advances made by the investor other than accounts receivable in the ordinary course of business). For purposes of determining when the accumulated share of investee losses exceeds the investment, it is appropriate to consider deferred intercompany profits (as discussed in CG 4.5.2.2) as being a reduction in the carrying amount of the investment. The investor should also consider any other comprehensive income (OCI) amounts recorded by the investor that relate to its equity method investment in determining its investment balance. We believe that the carrying amount of the equity method investment should include the effects of any OCI amounts, except for OCI related to foreign currency translation adjustments. ASC 830-30-40-2 is clear that any effects from foreign currency translation adjustments should be excluded from the carrying value of an equity method investment when assessing it for impairment.

There is a general presumption that losses should not be recognized in excess of the total investment (including any additional advances) unless the investor has guaranteed the investee’s obligations or has committed to provide further financial support to the investee. An exception to this principle exists when the investee’s return to profitability is imminent (see CG 4.5.4 for further information). This presumption under the equity method differs from consolidation procedures in ASC 810-10, which requires losses to continue to be attributed to the noncontrolling interest even if that results in a debit balance.

**ASC 323-10-35-20**

The investor ordinarily shall discontinue applying the equity method if the investment (and net advances) is reduced to zero and shall not provide for additional losses unless the investor has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee.
However, the recognition of losses in excess of the amount of the investment and in excess of any obligations to provide support may be appropriate in some circumstances. The exercise of judgment is required based on an analysis of the facts and circumstances of each case. The following are some of the factors that should be considered in making this assessment:

- **Legal and quasi-legal obligations**

  When the investor is legally obligated, by contract or agreement, to assume, underwrite, or guarantee investee obligations, recognition of the investor’s share of the losses in excess of its investment is required.

  When an investor has guaranteed investee obligations, the question arises as to whether the investor should only record its proportionate share of the investee's losses, or if it also should record the losses allocable to the other investors. If the investor is legally obligated to fund more than its portion of the investee losses (i.e., other investors are not obligated to fund losses), the investor will generally be required to record investee losses otherwise allocable to other investors, since it is likely that such other investors will not bear their share.

  Where the other investors are obligated to fund their proportionate share, the determination as to whether another investor will fund a portion of the investee's losses should be based on the ability of the other investor to fund if necessary, and not on the probability that the investee will require funding. If it is probable that the other investors will not fund their portion of the investee losses, the investor is required to record the entire loss of the investee up to its legal obligation beyond its proportionate share. This could occur because the other investors who are legally obligated to provide support choose not to, or lack the financial capability to fund.

  Consideration should also be given to joint and several liability arrangements where the lender can demand payment of the total amount from any one of the obligors (investors) or combination of obligors. The paying investor may be able to pursue payment from the other investors, but again would need to consider the likelihood that the other investors would be able to fund their obligations. The obligor would need to measure its obligation at the sum of (1) the amount that the obligor agreed with its co-obligors that it would pay, plus (2) any additional amount the obligor expects to pay on behalf of its co-obligors. The accounting for joint and several liability arrangements is contained in ASC 405-40. See FG 2 for further information on the accounting for joint and several liability arrangements.

  In addition, losses in excess of the investment should ordinarily be recognized when the investor has a “quasi-legal” obligation to underwrite investee losses. A quasi-legal obligation is an obligation that is determined based on factors other than a strict obligation, such as the business relationship and credit standing of the other investors.

  When the investor has followed the practice of underwriting investee losses through advances, or there is a strong presumption that the investor would “make good” the obligations of an investee in order to preserve its credit rating, business reputation, or other important relationships, recognition of losses may be required even in the absence of a legally binding obligation.

  Determining whether the investor has a quasi-legal obligation requires judgment and, in certain circumstances, may be based predominantly on the intent of the investor. Where it is based predominantly on intent, and the investor has previously acted upon that intent by funding the...
investee, it would be difficult to support a change in intent not to fund the investee, absent the occurrence of an event or change in business strategy or the like.

Similar to legal obligations, the investor must consider whether the other investors also have a quasi-legal obligation and will bear their share of the losses. This determination is necessary in order to determine whether the investor should record losses otherwise allocable to other investors, in addition to its allocated losses. The requirements of ASC 460 should also be considered as they relate to such guarantees.

To the extent an investor is funding the losses of an investee, the investor should consider the provisions of the variable interest entity model to determine whether the investee may be a VIE and require consolidation by the investor. The funding of losses may also require a reconsideration of previous consolidation conclusions under ASC 810-10.

- **Publicly stated investor intentions**

  Public statements by the investor of its intention to abandon, or to continue to provide support to, an investee should be considered.

- **Operating considerations**

  Operating matters should also be considered to the extent practicable. For example, the following operating circumstances may indicate that the investor is unlikely to abandon the investee and, therefore, full recognition of losses in excess of the investor's investment is appropriate:

  - Investee losses are attributable to start-up costs, extraordinary losses, or similar circumstances that are considered temporary or nonrecurring, and a turnaround to profitable operations is expected.

  - The investee may be in an industry where accounting losses can be sustained more or less indefinitely without impairing the going concern assumption (e.g., real estate development companies).

  - The operation experiencing losses may integrate favorably with other consolidated operations.

  - The investor is a major supplier to or major purchaser from the investee.

  - The investor is dependent on the investee for strategic development processes (for example, research and development or new technologies).

  - Any other factors indicating that the investor has an incentive to protect and support the investee.

The above examples are merely illustrative of some of the operating matters that may arise. The key consideration from an operating perspective is whether the investor would abandon the investee. This assessment is a matter of facts and circumstances and is based on the investor’s relationship with the investee and the other investors.
4.5.3.1 Changes of interest after suspension of equity method losses

An issue arises when an investor makes a subsequent investment in an investee after the investor has suspended recognizing equity method losses of the investee.

An investor should consider whether the subsequent investment provides the investor with a controlling financial interest in the investee. If the investor gains a controlling financial interest in the investee, the investor would follow the acquisition guidance in ASC 805. See CG 4.7 for further discussion on the accounting for changes in interest.

When an additional investment does not provide an investor with a controlling financial interest in an investee, the investor should consider whether the additional investments, in whole or in part, represent, in substance, the funding of prior losses or an additional investment. The investor should recognize previously suspended losses only up to the amount of the additional investment determined to represent the funding of prior losses. The investor should also consider whether it has otherwise become committed to provide financial support to the investee on making an additional investment.

Whether an investment represents the funding of prior losses depends on the facts and circumstances. Judgment is required to determine whether prior losses are being funded. All available information should be considered in performing the related analysis. ASC 323 provides some additional factors for consideration.

ASC 323-10-35-29

If a subsequent investment in an investee does not result in the ownership interest increasing from one of significant influence to one of control and, in whole or in part, represents, in substance, the funding of prior losses, the investor should recognize previously suspended losses only up to the amount of the additional investment determined to represent the funding of prior losses (see (b)). Whether the investment represents the funding of prior losses, however, depends on the facts and circumstances. Judgment is required in determining whether prior losses are being funded and all available information should be considered in performing the related analysis. All of the following factors shall be considered; however, no one factor shall be considered presumptive or determinative:

a. Whether the additional investment is acquired from a third party or directly from the investee. If the additional investment is purchased from a third party and the investee does not obtain additional funds either from the investor or the third party, it is unlikely that, in the absence of other factors, prior losses are being funded.

b. The fair value of the consideration received in relation to the value of the consideration paid for the additional investment. For example, if the fair value of the consideration received is less than the fair value of the consideration paid, it may indicate that prior losses are being funded to the extent that there is disparity in the value of the exchange.

c. Whether the additional investment results in an increase in ownership percentage of the investee. If the investment is made directly with the investee, the investor shall consider the form of the investment and whether other investors are making simultaneous investments proportionate to their interests. Investments made without a corresponding increase in ownership or other interests, or a pro rata equity investment made by all existing investors, may indicate that prior losses are being funded.
d. The seniority of the additional investment relative to existing equity of the investee. An investment in an instrument that is subordinate to other equity of the investee may indicate that prior losses are being funded.

4.5.3.2 Investor holds other investments in the investee (equity method)

When an investor’s total investment in an investee includes investments other than common stock, such as preferred stock and loans, the investor would continue to recognize investee losses up to the investor’s carrying value in those other investments. The recognition of losses would include any additional financial support made or committed to by the investor. An investment considered to be in-substance common stock may generally be grouped with, and considered, common stock for the purposes of performing the investee loss allocations required.

ASC 323-10-35-25

The cost basis of the other investments is the original cost of those investments adjusted for the effects of other-than-temporary write-downs, unrealized holding gains and losses on debt securities classified as trading in accordance with Subtopic 320-10 or equity securities accounted for in accordance with Subtopic 321-10 and amortization of any discount or premium on debt securities or loans. The adjusted basis is the cost basis adjusted for the valuation allowance account recognized in accordance with Subtopic 310-10 for an investee loan and the cumulative equity method losses applied to the other investments. Equity method income subsequently recorded shall be applied to the adjusted basis of the other investments in reverse order of the application of the equity method losses (that is, equity method income is applied to the more senior investments first).

The order in which equity method losses should be applied to the other investments should follow the seniority of those other investments beginning with the most subordinated. For each period, the basis of the other investments should first be adjusted for the equity method losses, and then may need to be further adjusted after applying the relevant impairment guidance for those investments.

For example, if an investor invests in both common stock and preferred stock in the investee and subsequently records its share of equity method losses to the extent of its common stock investment, the investor should then continue to recognize equity method losses to the extent of, and as an adjustment to, the cost basis of the preferred stock (the next most senior security). Advances to the investee in the form of debt would continue to be accounted for by the investor in accordance with the provisions of an impairment of a loan by a creditor. Once the cost basis of the investment in the preferred stock reaches zero, investee losses would be recognized to the extent that the net carrying amount of the debt (net of any valuation account or amortization) exceeded zero. At all times, the preferred stock would require a write-up (or write-down) to fair value through income if it is an equity security as defined in ASC 321 (absent applying the measurement alternative) or through OCI if it is a debt security as defined in ASC 320 (and reported as available for sale).
Excerpt from ASC 323-10-35-24

[T]he investor shall continue to report its share of equity method losses in its statement of operations to the extent of and as an adjustment to the adjusted basis of the other investments in the investee. The order in which those equity method losses should be applied to the other investments shall follow the seniority of the other investments (that is, priority in liquidation). For each period, the adjusted basis of the other investments shall be adjusted for the equity method losses, then the investor shall apply Subtopic 310-10 320-10 and 321-10 to the other investments, as applicable.

When an investor’s investment in common stock has been reduced to zero and it has other investments in the investee, the investor should generally not recognize equity method losses against its other investments based solely on its percentage of investee common stock held. In such instances, there are two acceptable methods that could be applied. An investor would either recognize investee losses based on (1) the ownership level of the particular investee security or loan/advance held by the investor to which the equity method losses are being applied, or (2) the change in the investor’s claim on the investee book value.

Excerpt from ASC 323-10-35-28

[T]he investor shall not recognize equity method losses based solely on the percentage of investee common stock held by the investor. Example 5 (see paragraph 323-10-55-48) illustrates two possible approaches for recognizing equity method losses in such circumstances.

Example 4-32 illustrates one approach that an investor may apply in order to attribute investee losses to different investments it holds. For another example, see CG 4.5.1.3 from ASC 323-10-55-49.

EXAMPLE 4-32
Attribute of investee losses when an investor holds other investments

On January 1, 20X5, Company XYZ began its operations with three investors, Company A, Company B, and Company C.

Company A acquired 1,000,000 shares of Company XYZ’s common stock for $1 per share and loaned Company XYZ $1,000,000 in cash.

Company B acquired 750,000 shares of Company XYZ’s common stock for $1 per share and 1,000,000 shares of Series A voting preferred stock (preferred stock) in Company XYZ for $2 per share. The preferred stock is not considered in-substance common stock.

Company C acquired 750,000 shares of Company XYZ’s common stock for $1 per share.

Company A, Company B, and Company C properly account for their respective investments in common stock under the equity method of accounting.

For simplicity, this example assumes the preferred stock is measured using the measurement alternative with no observable changes in fair value or impairment under ASC 321, Investments – Equity Securities, and the loan was not impaired under ASC 310, Receivables (or ASC 326 Financial Instruments - credit losses once adopted).
Equity method of accounting

Company XYZ incurred losses of $2,500,000 and $2,750,000 in 20X5 and 20X6, respectively. None of Company XYZ’s investors is required to provide additional financial support. Assume that Company XYZ is not a VIE.

What is Company A, Company B, and Company C’s share of Company XYZ’s losses for 20X5 and 20X6?

**Analysis**

The following table illustrates how Company A, B, and C should account for the losses in Company XYZ for 20X5 and 20X6, given their investments in Company XYZ.

<table>
<thead>
<tr>
<th>Company</th>
<th>Common Stock</th>
<th>Loan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company A</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Company B</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Company C</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
**Company B**

<table>
<thead>
<tr>
<th>Common Stock</th>
<th>Preferred Stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity investment in Company XYZ - 1/1/20X5</td>
<td>$750,000</td>
</tr>
<tr>
<td>Company B’s share of 20X5 net losses (($2,500,000) × 30%)</td>
<td>(750,000)</td>
</tr>
<tr>
<td>Equity investment in Company XYZ - 12/31/20X5 (A)</td>
<td>—</td>
</tr>
<tr>
<td>Company B’s share of 2006 net losses [that is, $2,750,000, of which $2,000,000 is first applied to preferred stock]</td>
<td>—</td>
</tr>
<tr>
<td>Equity investment in Company XYZ - 12/31/20X6 (B)</td>
<td>—</td>
</tr>
</tbody>
</table>

**Company C**

<table>
<thead>
<tr>
<th>Common Stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity investment in Company XYZ - 1/1/20X5</td>
</tr>
<tr>
<td>Company C’s share of 20X5 of net losses (($2,500,000) × 30%)</td>
</tr>
<tr>
<td>Equity investment in Company XYZ - 12/31/20X5 (A)</td>
</tr>
<tr>
<td>Company C’s share of 20X6 net losses</td>
</tr>
<tr>
<td>Equity investment in Company XYZ - 12/31/20X6 (B)</td>
</tr>
</tbody>
</table>

**A** – In 20X5, all of Company XYZ’s losses ($2,500,000) should be allocated proportionately to the common stock held by Companies A, B, and C. As a result, at December 31, 20X5, the investment balance of Companies A, B, and C in the common stock of Company XYZ have all been reduced to zero due to the allocation of their proportionate share of Company XYZ’s net loss. This allocation was based on the percentage of common stock owned by each investor, not on the percentage ownership of total voting stock. As noted above, the preferred stock is not in-substance common stock for purposes of this example.

**B** – Because each company’s equity investment in Company XYZ is zero, in 20X6, the $2,750,000 net loss must be allocated to the next most senior level of capital (the $2,000,000 of preferred stock held by Company B), and then, the remaining amount ($750,000) is allocated to Company A’s loan. Accordingly, at December 31, 20X6, Company B’s preferred stock investment in Company XYZ has been reduced to zero, since all of the preferred stock investment, as it is the most senior, is first applied against the $2,750,000 net loss. Similarly, at December 31, 20X6, Company A’s loan
investment in Company XYZ has been reduced to $250,000 since the remaining portion of the net loss ($750,000) is secondarily applied against the loan investment balance.

4.5.4 Recognizing losses - imminent return to profitability (equity method)

Losses are required to be recognized by an investor in excess of its investment when the imminent return to profitability by the investee is assured. This determination requires the exercise of judgment.

**ASC 323-10-35-21**

An investor shall, however, provide for additional losses if the imminent return to profitable operations by an investee appears to be assured. For example, a material, nonrecurring loss of an isolated nature may reduce an investment below zero even though the underlying profitable operating pattern of an investee is unimpaired.

4.5.4.1 Losses in excess of investment not recognized - restoration of investment (equity method)

In accordance with ASC 323-10-35-22, when investee losses in excess of the investment are not recognized by the investor and the investee subsequently reports net income or OCI, the investor generally should resume applying the equity method and, absent any investee capital transactions, recognize its proportionate share of the investee’s net income and OCI only after the investee’s shareholders’ deficit is eliminated (i.e., once the investor has equity in the net assets of the investee).

When this procedure is followed, the “share of net losses not recognized” should be the aggregate of the investor’s share of investee losses and the normal amortization of any excess costs assigned to specific tangible and intangible assets (see CG 4.5.5.1) that would have been charged to income during the period when losses were not recognized.

**Excerpt from ASC 323-10-35-26**

b. 2. If the adjusted basis reaches zero, equity method losses shall cease being reported; however, the investor shall continue to track the amount of unreported equity method losses for purposes of applying paragraph 323-10-35-20. If one of the other investments is sold at a time when its carrying value exceeds its adjusted basis, the difference between the cost basis of that other investment and its adjusted basis at the time of sale represents equity method losses that were originally applied to that other investment but effectively reversed upon its sale. Accordingly, that excess represents unreported equity method losses that shall continue to be tracked before future equity method income can be reported.

When an investee returns to profitability, an investor generally restores its investment balance only to the extent of the investor’s equity in net assets of the investee. This methodology would preclude an investor from restoring the remaining balance of any unamortized basis differences that were established at the investment date that were not recognized after losses reduced the investor’s investment balance to zero. Example 4-33 illustrates the methodology that is generally employed when an investor restores its investment balance after (1) an investor does not recognize investee losses in excess of its investment balance and (2) an investee returns to profitability.
EXAMPLE 4-33

Restoration of investment when losses in excess of investment not recognized

Investor pays $100 for a common stock investment in Investee and determines that it is able to exercise significant influence over Investee. At the date of acquisition, Investor’s share of Investee net assets is $70. Investor determines that the $30 excess cost over net assets of Investee relates entirely to a manufacturing plant. The excess cost assigned to plant is being depreciated on a straight-line basis over 10 years.

Investee has incurred losses for the first three years. Investor’s share of those losses amounted to $40 per year. Investee is profitable in year four and five and Investor’s share is $70 in each of those years.

<table>
<thead>
<tr>
<th>Year</th>
<th>Investor share of Investee income (loss)</th>
<th>Depreciation of excess cost assigned to plant</th>
<th>Equity in net income of Investee (loss) reported by Investor</th>
<th>Period-end investment balance</th>
<th>Composition of ending investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$(40)</td>
<td>$(3)</td>
<td>$(43)</td>
<td>$57</td>
<td>$30 $27</td>
</tr>
<tr>
<td>2</td>
<td>(40)</td>
<td>(3)</td>
<td>(43)</td>
<td>14</td>
<td>(10) 24</td>
</tr>
<tr>
<td>3</td>
<td>(40)</td>
<td>(3)</td>
<td>(14)</td>
<td>—</td>
<td>(50) 0</td>
</tr>
<tr>
<td>4</td>
<td>70</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>20 0</td>
</tr>
<tr>
<td>5</td>
<td>70</td>
<td>70</td>
<td>90</td>
<td>90</td>
<td>0</td>
</tr>
</tbody>
</table>

In year 3, Investor recorded losses that reduced the carrying amount of its investment to zero, resulting in the elimination of the remaining unamortized excess cost element.

In year four, Investor restored its investment only to the extent of Investor’s equity in net assets of Investee. In this case, Investor did not restore the excess cost element of its investment balance. As such, in year four, Investor’s proportionate share of Investee’s net income is limited to $20 ($20 = ($50) + $70).

In some cases, it may also be appropriate for Investor to restore the remaining balance of any unamortized basis differences that were established at the investment date that were not recognized after losses reduced the investor’s investment balance to zero.

4.5.5 Other adjustments to the share of earnings of the investee (equity method)

In addition to amortizing basis differences between the investor’s cost and the underlying equity in net assets of the investee at the date of investment (see CG 4.4.5 for further details), an investor may need to make other adjustments to its share of earnings or losses of the investee, including to:

- Recognize an investor’s share of changes in the investee capital accounts, including items of other comprehensive income (see CG 4.4.5.5, CG 4.5.5.2, and CG 4.7 for further details).
- Address certain differences in accounting principles (see CG 4.5.6 for further details).
□ Eliminate intercompany gains and losses (see CG 4.5.2 for further details).

□ Recognize the receipt of dividends, which are applied as a reduction of the carrying amount of the investment.

□ Recognize impairments at the investor level (see CG 4.6 for further details).

4.5.5.1 Investor cost and underlying equity in net assets (equity method)

The difference between the investor’s cost and its underlying equity in net assets of the investee that is attributed to tangible and separately identifiable intangible assets should be amortized as a component of the investor’s share of earnings or losses of the investee. See CG 4.4.5 for further information.

Differences that are attributed to goodwill would not be amortized unless the PCC alternative has been elected. See CG 4.4.5.6 for further information.

If an investee disposes of an asset in which the investor has a basis difference, the related basis difference should be written off by the investor, which will affect the equity in earnings recognized by the investor (i.e., investor would recognize a gain or loss equal to the investor’s proportionate share of the investee’s reported gain or loss, adjusted to reflect the write-off of the investor’s basis difference attributed to the disposed asset).

If an investee records an impairment charge on its long-lived assets under ASC 360, the investor should review its outside basis in such assets in order to determine whether any adjustments to its proportionate share of the investee’s recorded impairment loss are necessary. For example, an investee may recognize a $100 impairment charge on its long-lived assets under ASC 360. If an investor owns a 40% interest in the voting common stock of the investee and has a $20 basis difference attributed to the long-lived assets (i.e., the investor’s carrying value in the investee’s long-lived assets is higher than the investee’s carrying value) at the impairment date, a $60 impairment charge would be included in the investor’s equity in earnings (i.e., its proportionate share of the investee’s reported impairment charge of $40, adjusted to reflect the write-off of the investor’s $20 basis difference attributed to the long-lived assets). See CG 4.6.2 for further information on the impact of impairments recognized by the investee on the investor’s financial statements.

4.5.5.2 Other comprehensive income considerations (equity method)

If an investee records an increase or decrease in OCI, the investor should record a corresponding proportionate increase or decrease in its equity method investment, along with a credit or debit to its OCI account. For example, if the investee records an increase in the fair value of its available-for-sale debt securities, the investor would record a proportionate increase in its OCI and equity method investment.
An investor shall record its proportionate share of the investee's equity adjustments for other comprehensive income (unrealized gains and losses on available-for-sale securities; foreign currency items; and gains and losses, prior service costs or credits, and transition assets or obligations associated with pension and other postretirement benefits to the extent not yet recognized as components of net periodic benefit cost) as increases or decreases to the investment account with corresponding adjustments in equity. See paragraph 323-10-35-37 for related guidance to be applied upon discontinuation of the equity method.

An investor should generally not record investee losses in excess of its investment and any additional advances whether through net income or OCI, unless the investor has guaranteed the investee’s obligations or has committed to provide further financial support to the investee. See CG 4.5.3.

**Accounting for cumulative OCI upon the sale of an interest in investee**

In certain instances, an investor that sells a portion of its interest in the investee should recognize a gain or loss on the sale of those shares. The basis of the investment used to determine the gain or loss would include the investor’s cumulative OCI relating to the investment. The investor would record a corresponding reclassification adjustment for the credit or debit balance in OCI (i.e., the investor would reclassify the amounts in OCI to earnings under ASC 220, Comprehensive Income). See CG 4.7.6 for further information on sales of investee shares.

**Accounting for cumulative translation adjustment relating to an equity method investment**

The investor’s determination of whether to release any cumulative translation adjustment relating to an equity method investment depends on whether the investment is in or contained within a foreign entity. A foreign entity may consist of various entities including an equity method investment or may be the equity investment itself. If the equity method investment is not itself a foreign entity, but is part of a foreign entity (within), the cumulative translation adjustment is released into net income only if the partial sale represents a complete or substantially complete liquidation of the broader foreign entity that contains the equity method investment. A partial sale of an equity method investment that is itself a foreign entity requires a pro rata portion of the cumulative translation adjustment to be released into net income. See FC 8 for more information.

**4.5.5.3 Share of other items reported by investee (equity method)**

An investor’s share of prior period adjustments that are reported in the financial statements of the investee should be classified in a similar manner by the investor in its income statement.

However, issues can arise when an error or other adjustment reported by the investee relates to a period prior to when the investor made its investment. In these cases, the portion of the investor’s share of the investee prior period adjustment that pre-dates the investment would be treated as an adjustment to the investor’s prior period inventory difference, which would need to be assigned based on the investee’s revised balance sheet amounts as of the investment date. Depending upon the underlying reasons for the adjustment to the investee’s financial statements, the investor may need to consider whether its investment is impaired.
An investor should generally not report discontinued operations in its income statement for its share of the discontinued operations of an equity method investee. If the investee reports a discontinued operation, the investor should consider whether this represents a strategic shift that has (or will have) a major effect on its own operations and financial results and, therefore, also requires discontinued operation presentation by the investor. See FSP 27 for further information on the presentation of discontinued operations. If the investor does not report discontinued operations, it would report its share of the investee’s discontinued operations in the income statement line used for its share of the investee’s earnings or losses.

4.5.5.4 **Stock-based compensation awarded by investee to its employees (equity method)**

The accounting for stock-based compensation awarded by an investee to its own employees results in the recognition of compensation cost in net income in the investee’s financial statements over the vesting period. The investor would therefore recognize its proportionate share of the compensation expense.

When the stock-based compensation is equity classified, the investee records expense with an offsetting entry to additional paid-in-capital, the net effect of which does not change the investee’s reported equity. The investor would record its proportionate share of the investee’s stock-based compensation expense. The question then arises as to how the investor should account for its share of the investee’s “credit” entry to additional paid-in-capital.

Generally, an investor accounts for change in interest transactions only when common shares have been issued by the investee. Therefore, during the vesting period, the investor would generally track its share of the investee’s credit to additional paid-in-capital in its equity method memo accounts as a reconciling item. Alternatively, the investor could record the adjustment in its own equity with a corresponding increase in the investment account similar to how an investee’s OCI movements are treated by an investor (see CG 4.5.5.2 for further information).

However, we do not believe the investor should record its share of the investee’s increase in additional paid-in-capital as part of its share of earnings of the investee. This would effectively result in the investor not recording its share of the investee’s compensation expense. In addition, in certain instances, it may result in a subsequent charge to earnings.

The exercise of an option or vesting of restricted shares decreases the investor’s percentage ownership in the investee. Therefore, the investor should account for a change in interest as an indirect sale of a portion of its interest in the investee. Regardless of how the investor accounts for the investee’s increase in additional paid-in-capital, the investor should adjust its investment for a change in its share of the investee’s net assets upon exercise of the option or for the vesting of restricted shares. See CG 4.7 for further information on accounting for change in interest transactions.

4.5.5.5 **Stock-based compensation awarded by investor to investee employees (equity method)**

The accounting for stock-based compensation that is awarded by an investor to employees of its equity method investee can have an impact on both the reported investment and the investor’s share of the earnings or loss of the equity method investment.

If an investor sponsors a stock-based compensation plan for its investee’s employees, and the other investors do not provide proportionate value to the investee or the investor does not receive any
consideration, such as an increase in its relative ownership percentage of the investee for the awards, the investor should expense the entire cost associated with the award when the investee recognizes the related expense in its books. This assumes that the awards were not agreed to and accounted for as part of the investor’s acquisition of an interest in the investee.

Investors that do not participate in the investee’s stock-based compensation plan are also impacted. Such investors would recognize their respective share of the expense recorded by the investee as part of the share of earnings or losses of the investee. In addition, as the investee would have recorded an increase in its capital for the stock-based compensation contributed by the investor sponsoring the plan, the other non-contributing investors would also record their share of the investee’s increase in net assets as part of their share of earnings or losses, with a corresponding increase in their equity method investment. See SC 7.2 for further information.

ASC 323-10-25-3

Paragraphs 323-10-25-4 through 25-6 provide guidance on accounting for share-based payment awards granted by an investor to employees or nonemployees of an equity method investee that provide goods or services to the investee that are used or consumed in the investee’s operations when no proportionate funding by the other investors occurs and the investor does not receive any increase in the investor’s relative ownership percentage of the investee. That guidance assumes that the investor's grant of share-based payment awards to employees or nonemployees of the equity method investee was not agreed to in connection with the investor’s acquisition of an interest in the investee. That guidance applies to share-based payment awards granted to employees or nonemployees of an investee by an investor based on that investor’s stock (that is, stock of the investor or other equity instruments indexed to, and potentially settled in, stock of the investor).

ASC 323-10-25-4

In the circumstances described in paragraph 323-10-25-3, a contributing investor shall expense the cost of share-based compensation granted to employees and nonemployees of an equity method investee as incurred (that is, in the same period the costs are recognized by the investee) to the extent that the investor’s claim on the investee’s book value has not been increased.

ASC 323-10-25-5

In the circumstances described in paragraph 323-10-25-3, other equity method investors in an investee (that is, noncontributing investors) shall recognize income equal to the amount that their interest in the investee’s net book value has increased (that is, their percentage share of the contributed capital recognized by the investee) as a result of the disproportionate funding of the compensation costs. Further, those other equity method investors shall recognize their percentage share of earnings or losses in the investee (inclusive of any expense recognized by the investee for the stock-based compensation funded on its behalf).

The following excerpt is from an example included in ASC 323 that demonstrates an investor’s application of the approach for stock-based compensation awarded to employees of an equity method investee by the investor. Only the facts and the journal entries from that example have been included below. See ASC 323-10-55-19 through ASC 323-10-55-26 for the comprehensive example.
This Example illustrates the guidance in paragraphs 323-10-25-3 and 323-10-30-3 for share-based compensation by an investor granted to employees of an equity method investee. This Example is equally applicable to share-based awards granted by an investor to nonemployees that provide goods or services to an equity method investee that are used or consumed in the investee’s operations.

Entity A owns a 40 percent interest in Entity B and accounts for its investment under the equity method. On January 1, 20X1, Entity A grants 10,000 stock options (in the stock of Entity A) to employees of Entity B. The stock options cliff-vest in three years. If an employee of Entity B fails to vest in a stock option, the option is returned to Entity A (that is, Entity B does not retain the underlying stock). The owners of the remaining 60 percent interest in Entity B have not shared in the funding of the stock options granted to employees of Entity B on any basis and Entity A was not obligated to grant the stock options under any preexisting agreement with Entity B or the other investors. Entity B will capitalize the stock-based compensation costs recognized over the first year of the three-year vesting period as part of the cost of an internally constructed fixed asset (the internally constructed fixed asset will be completed on December 31, 20X1).

Before granting the stock options, Entity A’s investment balance is $800,000, and the book value of Entity B’s net assets equals $2,000,000. Entity B will not begin depreciating the internally constructed fixed asset until it is complete and ready for its intended use and, therefore, no related depreciation expense (or compensation expense relating to the stock options) will be recognized between January 1, 20X1, and December 31, 20X1. For the years ending December 31, 20X2, and December 31, 20X3, Entity B will recognize depreciation expense (on the internally constructed fixed asset) and compensation expense (for the cost of the stock options relating to Years 2 and 3 of the vesting period). After recognizing those expenses, Entity B has net income of $200,000 for the fiscal years ending December 31, 20X1, December 31, 20X2, and December 31, 20X3.

Entity C also owns a 40 percent interest in Entity B. On January 1, 20X1, before granting the stock options, Entity C’s investment balance is $800,000.

Assume that the fair value of the stock options granted by Entity A to employees of Entity B is $120,000 on January 1, 20X1. Under Topic 718, the fair value of share-based compensation should be measured at the grant date. This Example assumes that the stock options issued are classified as equity and ignores the effect of forfeitures.

Entity A would make the following journal entries.
Equity method of accounting

Entity A (Contributing Investor)

<table>
<thead>
<tr>
<th></th>
<th>12/31/20X1</th>
<th>12/31/20X2</th>
<th>12/31/20X3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in Entity B (a)</td>
<td>$16,000</td>
<td>$16,000</td>
<td>$16,000</td>
</tr>
<tr>
<td>Expenses</td>
<td>24,000</td>
<td>24,000</td>
<td>24,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>$40,000</td>
<td>$40,000</td>
<td>$40,000</td>
</tr>
</tbody>
</table>

Entity C (noncontributing Investor)

<table>
<thead>
<tr>
<th></th>
<th>12/31/20X1</th>
<th>12/31/20X2</th>
<th>12/31/20X3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in Entity B</td>
<td>$16,000</td>
<td>$16,000</td>
<td>$16,000</td>
</tr>
<tr>
<td>Contribution income (c)</td>
<td>$16,000</td>
<td>$16,000</td>
<td>$16,000</td>
</tr>
</tbody>
</table>

To record cost of stock compensation and Entity C’s additional Investment for costs incurred by Entity A on behalf of investee

(a) Entity A recognizes as an expense the portion of the costs incurred that benefits the other investors (in this Example, 60 percent of the cost or $24,000 in 20X1, $36,000 in 20X2, and $12,000 in 20X3) and recognizes the remaining cost (40 percent) as an increase to the investment in Entity B. As Entity B has recognized the cost associated with the stock-based compensation incurred on its behalf, the portion of the cost recognized by Entity A as an increase to its investment in Entity B (40 percent) is expensed in the appropriate period when Entity A recognizes its share of the earnings of Entity B.

(b) It may be appropriate to classify the debit (expense) within the same income statement caption as equity in earnings of Entity B.

(c) This amount represents Entity C’s 40 percent interest in the additional paid-in capital recognized by Entity B related to the cost incurred by the third party investor. It may be appropriate to classify the credit (income) within the same income statement caption as equity in earnings of Entity B.
4.5.6 Differences in accounting principles (equity method)

An investor and investee may apply different accounting principles in the preparation of their financial statements. In these cases, an investor may be required to adjust the investee’s financial statements when determining its share of the investee’s earnings.

4.5.6.1 Investee applies US GAAP (equity method)

The investee is ultimately responsible for the selection of its accounting policies. The investee may apply different accounting policies than the investor provided they are an acceptable alternative under US GAAP. For example, an investee could apply the FIFO method for its inventory when the investor applies the LIFO method. When the investor and the investee apply different accounting policies, the investor does not need to adjust the investee’s financial statements before recording its proportionate share of the investee’s earnings.

However, care must be taken in the elimination of intercompany profits and losses to avoid the recognition of profit or loss that result merely because the investor and investee account for transferred items differently. For example, an investor and investee may be counterparties in a long-term natural gas supply contract where the investor accounts for the contract as a derivative instrument pursuant to ASC 815, Derivatives and Hedging (i.e., on a mark-to-market basis, with changes in fair value being reported in earnings) and the investee elects the normal-purchase, normal-sale scope exception, which results in the investee accounting for such contract on an accrual basis. The investor may have to eliminate unrealized intercompany profits and losses recognized on such a contract, which may include eliminations at inception, during the term, and at the end of the contract, within its financial statements because the earnings process is not yet complete. See CG 4.5.2 for further information on the elimination of intercompany profits on transactions between an investor and an investee.

4.5.6.2 Investee does not apply US GAAP (equity method)

An investor reporting under US GAAP is required to record its share of earnings or losses and other changes in net assets of the investee using investee financial statements that are prepared under US GAAP. The investor should therefore arrange for the investee to prepare financial statements in accordance with US GAAP, or it should obtain the information necessary to adjust the investee’s financial statements to US GAAP when the investee’s financial statements have been prepared in accordance with other acceptable alternatives (e.g., IFRS, other GAAP, or accounting principles prescribed by a regulatory agency). If the investee does not provide US GAAP financial information to the investor for purposes of determining its share of investee’s earnings, the investor will need to convert the investee’s financial information to US GAAP. In cases when an investee’s policies under other GAAP (e.g., IFRS) are not acceptable alternatives under US GAAP, the investor should conform the investee’s financial information using policies consistent with its own policies.

4.5.6.3 Investee applies industry-specific accounting principles (equity method)

If an investee uses industry-specific accounting principles when preparing its own financial statements, the investor is required to retain the industry-specific accounting principles in its application of the equity method.
For the purposes of applying the equity method of accounting to an investee subject to guidance in an industry-specific Topic, an entity shall retain the industry-specific guidance applied by that investee.

The requirement for an investor to retain the industry-specific guidance applied by its investee is consistent with the consolidation guidance that similarly requires industry-specific accounting applied by a subsidiary be retained in its parent’s financial statements.

**4.5.6.4 Investee applies private company accounting alternatives (equity method)**

A public company investor may have an interest in a private company investee that has elected an accounting alternative (“PCC alternative”) approved by the PCC and endorsed by the FASB, such as the goodwill accounting alternative discussed in CG 4.4.5.6. A public company investor should eliminate the effects of its private company investee’s application of such PCC alternatives because such PCC alternatives are not available to public company investors.

**4.5.6.5 New accounting principles adopted by investee at different time (equity method)**

It is common for new accounting principles to allow early adoption or allow a delayed mandatory adoption date for private companies. If the investee adopts an accounting principle prior to it being adopted by the investor, the investor is not required to eliminate the effects of the adoption by the investee in its (investor) financial statements. Similarly, if an investee adopts a new accounting principle later than the investor, the investor is not required to impose its decision to adopt the new principle on the investee on the date in which the investor adopts the new principle (i.e., the investee is not required to adopt the new principle on the date in which the investor adopts the new principle). However, care must be taken in the elimination of intercompany transactions to avoid the recognition of profit or loss that result merely because the investor and investee account for the transactions differently as a result of the adoption of a new accounting principle.

**4.5.7 Lag in investee reporting (equity method)**

The financial statements of an investee may not be available in sufficient time for the investor to apply the equity method as of the current reporting date. In this case, the investor ordinarily would record its share of the earnings or losses of the investee using the most recent available financial statements. We believe that “ordinarily,” as used in ASC 323-10-35-6, was intended to permit the use of financial statements of the investee as of a date earlier than the “most recent available” financial statements if the earlier date is the investee’s fiscal year end, or a date for which audited financial statements are available.

The determination of whether an investee’s results are recorded on a lag is made on an investment-by-investment basis. Therefore, each investment should be assessed separately to determine if a lag in investee reporting is necessary.

While the equity method of accounting model does not specify a limit on the extent of the lag period, the provisions relating to consolidation of subsidiaries with fiscal periods different from the parent offer a reasonable guideline (see extract below). That is, the difference in fiscal periods should not be more than about three months.
When results of the investee included in the investor’s annual financial statements are recorded on a lag, they should still be the results for a full 12 months, albeit for a different 12 months than those of the investor’s standalone results. Including the investee’s results for a period greater or less than 12 months in the investor’s annual financial statements is generally not appropriate. A time lag in reporting should be consistent from period to period. See CG 4.5.7.1 for information regarding the investor’s accounting for a new investment that is reported on a lag.

The investor should give recognition to the effect of any known events occurring during the lag period that materially affect the financial position or results of operations of the investee if those events are also material to the financial position or results of operations of the investor. Recognition in this context does not necessarily mean that the investor should record an adjustment to its proportionate share of the investee’s earnings. Rather, in many cases, an investor should recognize the events through disclosure only.

An investor that gives recognition by adjustment for material events occurring during the intervening period should apply that approach on a consistent basis. However, it can be challenging to determine a threshold for when to adjust for some, but not all, intervening events in order to apply a consistent approach from one period to the next. The investor would also need to track adjustments to ensure it does not record its share of transactions or events more than once in subsequent periods. Therefore, in practice, many companies follow a policy of disclosing rather than adjusting for material intervening events.

4.5.7.1 Initial lag period (equity method)

An investor that acquires a new investment in an investee for which it will apply the equity method for the first time may elect to include the investee on a lag. In this case, the investor would include its share of the investee earnings from the date of acquisition through the end of the date selected for lag reporting (ordinarily the most recent available financial statements date) in the investor’s first reporting period. Example 4-34 illustrates an investor’s accounting for the acquisition of an equity method investment that is reported with a lag period.

**EXAMPLE 4-34**

Acquisition of equity method investment reported with a lag period

Investor, a public company with a calendar year end, acquires an equity method investment in Investee on December 1, 20X1, which will be accounted for on a two-month lag.

How should Investor record its share of Investee’s earnings for 20X1 and 20X2?
Analysis

In its fourth quarter 20X1 financial statements, Investor would record the acquisition of its interest in Investee at cost. However, Investor would not record any share of Investee earnings despite having owned the investment for the month of December.

In its first quarter 20X2 financial statements, Investor would include its share of Investee earnings for December 20X1 and January 20X2. Investor’s share of Investee earnings for the year ended 20X2 would include 11 months (December 1, 20X1 to October 31, 20X2).

4.5.7.2 Sale of interest when reporting on a lag (equity method)

When an investor disposes of all or a portion of its investment in an investee that it reported on a lag, it should generally reflect its share of the investee earnings in net income only up to the end of the date selected for lag reporting (ordinarily the most recently available financial statements date). An investor would usually record its gain or loss on sale of the investment when it is sold, and would not record the disposal on a lag.

Example 4-35 and Example 4-36 illustrate the sale of an interest in an investee reported on a lag period.

EXAMPLE 4-35

Sale of interest in an investee after the lag period

Investor, a public company with a calendar year end, has an equity method investment in Investee, which it accounts for on a three-month lag. Investor sells its equity investment in Investee on July 1, 20X2.

How should Investor record its share of Investee’s earnings through the date of sale?

Analysis

In its first and second quarter 20X2 financial statements, Investor would record its share of Investee’s earnings for the three months ended December 31, 20X1 and March 31, 20X2, respectively. In the third quarter, Investor would record its share of Investee’s earnings for the three-months ended June 30, 20X2. Investor would also recognize the gain or loss in earnings on the sale of Investee in its third quarter 20X2 financial statements.

In the example above, the investor sold its investment in the investee at the commencement of a lag period (i.e., July 1, 20X2). In this instance, the investor did not have to address how to record the investee’s earnings from the end of the previous quarter’s lag period (i.e., June 30, 20X2) through the date of the sale. However, in most cases, an investor does not sell its investment at the commencement of the lag period and the investor must determine how it should record investee earnings through the date of sale. In these cases, an investor should carefully consider how to record its share of the investee’s earnings through the sale date in order to not record earnings for a period greater than the investor’s reporting period. To avoid recording excess investee earnings, the investor can use a method analogous to the elimination of a lag (See CG 4.5.7.3).
Example 4-36 illustrates one method of accounting for a sale of an interest in an investee during a lag period.

**EXAMPLE 4-36**  
**Sale of interest in an investee during a lag period**

Investor, a public company with a calendar year end, has an equity method investment in Investee, which it accounts for on a three-month lag. Investor sells its equity investment in Investee on September 30, 20X2.

How should Investor record its share of Investee’s earnings through the date of sale?

**Analysis**

In the absence of a sale, Investor would record its share of Investee’s earnings for the three months ended June 30, 20X2 in the third quarter ended September 30, 20X2 because of the lag in recording its share of Investee’s earnings. However, where Investee had earnings during the period it was sold, recording a gain determined using Investor’s June 30, 20X2 investment balance would effectively result in also recording Investee earnings for the three-months ended September 30, 20X2 (i.e., the sales proceeds, based on the September 30, 20X2 fair values, reflect Investee’s earnings for the three-months ended September 30, 20X2). Recording earnings for the three-months ended June 30, 20X2 under Investor’s lag reporting as well as effectively recording Investee earnings for the three-months ended September 30, 20X2 through the gain on sale would inappropriately result in a total of six months of Investee earnings recognized in Investor’s third quarter financial statements.

In order to only record three-months of earnings in the third quarter, Investor could analogize to the accounting for the elimination of a lag period where the earliest period presented would be adjusted. For example, in this case, Investor would record Investee’s earnings for the three-months ended June 30, 20X2 directly to retained earnings. See CG 4.5.7.3 for further information on the accounting for changes to a lag in investee reporting.

**4.5.7.3**  
**Change to lag in investee reporting (equity method)**

The creation or elimination of a lag between investor and investee reporting periods, or a change to an existing lag period is considered a change in accounting principle, which requires the investor to demonstrate preferability before making the change. In addition, public companies are required to obtain a preferability letter from the investor’s independent auditor when the change is material. See FSP 30.4 for a discussion of changes in accounting principles.

**ASC 810-10-45-13**

A parent or an investor should report a change to (or the elimination of) a previously existing difference between the parent’s reporting period and the reporting period of a consolidated entity or between the reporting period of an investor and the reporting period of an equity method investee in the parent’s or investor’s consolidated financial statements as a change in accounting principle in accordance with the provisions of Topic 250. While that Topic generally requires voluntary changes in accounting principles to be reported retrospectively, retrospective application is not required if it is impracticable to apply the effects of the change pursuant to paragraphs 250-10-45-9 through 45-10. The change or elimination of a lag period represents a change in accounting principle as defined in
An investor that demonstrates preferability and eliminates a reporting lag should treat the change as any other change in accounting principle and adjust its financial statements for all periods presented as if the reporting lag never existed. For example, assume Investor, a calendar year end public company, eliminated the existing three-month reporting lag in the fourth quarter 20X1. Investor would adjust its 20X1 financial statements to reflect its share of investee’s earnings for the twelve-months ended December 31, 20X1. This adjustment would require Investor to reverse its share of Investee’s earnings for the three months ended December 31, 20X0, which, absent the elimination of the lag reporting, would have been recognized in its 20X1 financial statements. Such amounts would be recorded as a direct adjustment to the current period opening retained earnings balance as if such amounts were recognized in the prior period.

In practice, it is difficult to justify the preferability of a change in the reporting period of an investee that has the result of creating (or lengthening) a lag period. The inability to obtain timely information when such information was previously obtainable is unusual, and is generally not on its own a sufficient reason for introducing a lag in reporting. Further, the inability to obtain timely financial information may indicate that the investor does not have the ability to exert significant influence over an investee and the decision to use the equity method of accounting should be reevaluated (see CG 4.3.3 for a further discussion).

4.5.7.4 Availability of public information (equity method)

In instances where an investee is a public entity, certain laws may preclude an investor from disclosing information about a public investee that is not already publicly available. This situation can occur when the investee’s financial statements are not due to be filed until after those of the investor. As a result, the investor may elect to report its investment in the investee on a lag, provided such lag does not exceed three months.

Similarly, even when an investor elects the fair value option for an investment in a public company that would otherwise qualify for the equity method, difficulties may be encountered in providing the required equity method disclosures for that investee. In those instances, even though fair value is determined at the end of the current reporting period, it may be appropriate to provide the disclosures based on the most recent publicly available financial statements, as long as the lag does not exceed three months.

4.5.8 When equity method investee holds shares in investor

A reciprocal relationship exists when the investor and investee each hold an interest in the other’s stock. A question arises as to how the investor should account for its shares held by the investee. Two methods are commonly applied in practice to account for the reciprocal shareholding:

- The treasury stock method
The simultaneous equation method

While the treasury stock method may be more common in practice, the simultaneous equation method is also acceptable.

**Treasury stock method**

The treasury stock method is based on the concept that the equity method investor is the reporting entity. This method therefore considers the equity method investor’s stock held by the investee to be treasury stock of the investor. Accordingly, from this perspective, an investor’s net income would consist of the sum of the investor’s earnings from its own separate operations and the investor’s share of the equity method investee’s earnings from the investee’s separate operations. Therefore, there is no adjustment to the equity method investee’s earnings or losses for the return recognized on its investment in the equity method investor for the purposes of determining the investor’s share.

**Simultaneous equation method**

The simultaneous equation method, on the other hand, stems from the economic unit concept, whereby the investor and its investees are viewed as a single unit. From this perspective, the combined earnings of the equity method investor and the equity method investee should be presented in the investor’s income statement in such a manner that the amount that accrues to each of the classes of shareholders (the equity method investor “parent” and “noncontrolling” interest) is shown.

That is, the amount that accrues to the other investors (other than the equity method investor) in the combined economic unit, for example, would comprise the following amounts:

- The other investors’ interest in the equity method investee’s earnings from its own separate operations, exclusive of earnings from its investment in the parent, and

- The other investors’ interest in:
  - The parent’s earnings from its separate operations, and
  - The parent’s share of the equity investee’s earnings from the equity investee’s separate operations.

**4.5.9 Distributions in excess of carrying amount of investment (equity method)**

When an investor receives cash distributions in excess of the carrying amount of its investment in an investee, a question arises as to how the investor should account for the excess distribution. We believe that an investor should account for cash distributions received in excess of its investment in an investee as income when (a) the distributions are not refundable by agreement or by law and (b) the investor is not liable for the obligations of the venture and is not committed or expected to provide financial support to the venture. Otherwise, the investor should account for the excess distribution as a liability. Whether an investor has a non-legal commitment to provide financial support to an investee depends on the facts and circumstances surrounding an investor’s relationship with the investee and other investors. The considerations in assessing whether a non-legal obligation exists are similar to those set forth in CG 4.5.3.
If a general partner has an equity method investment in a limited partnership and receives cash distributions in excess of its investment balance, the excess distributions are recorded as a reduction of its partnership interest, even if it results in a negative net investment (liability). This treatment, consistent with ASC 970-323, is due to the general partner's ongoing obligation to support the partnership. However, if a limited partner investor in a limited partnership receives cash distributions in excess of its investment balance, gain recognition may be appropriate if it does not have an obligation (by agreement or law) or intent to fund future cash flow requirements of the partnership.

If an investor records an excess distribution from an equity method investee as income, the investor should generally not record its share of any subsequent investee income until it has recovered the excess distribution amount as reflected in its memo accounts. This approach is similar to the method applied for the recovery of unrecorded excess losses by the investor in ASC 323-10-35-22. If an investor records an excess distribution from an equity method investee as a liability (negative investment), the investor should record its portion of any subsequent investee income as equity income in the investor's income statement.

### 4.6 Impairment of an equity method investment

An investor is required to assess its equity method investment for impairment when events or circumstances suggest that the carrying amount of the investment may be impaired.

#### 4.6.1 Loss in investment value that is other than temporary (equity method)

An investor records an impairment charge in earnings when the decline in value below the carrying amount of its equity method investment is determined to be other than temporary. “Other than temporary” does not mean that the decline is of a permanent nature. The unit of account for assessing whether there is an other-than-temporary impairment (OTTI) is the carrying value of the investment as a whole.

**ASC 323-10-35-32**

A loss in value of an investment that is other than a temporary decline shall be recognized. Evidence of a loss in value might include, but would not necessarily be limited to, absence of an ability to recover the carrying amount of the investment or inability of the investee to sustain an earnings capacity that would justify the carrying amount of the investment. A current fair value of an investment that is less than its carrying amount may indicate a loss in value of the investment. However, a decline in the quoted market price below the carrying amount or the existence of operating losses is not necessarily indicative of a loss in value that is other than temporary. All are factors that shall be evaluated.

Continued operating losses at the investee may suggest that the investor would not recover all or a portion of the carrying value of its investment, and therefore that the decline in value is other than temporary.

**ASC 323-10-35-31**

A series of operating losses of an investee or other factors may indicate that a decrease in value of the investment has occurred that is other than temporary and that shall be recognized even though the decrease in value is in excess of what would otherwise be recognized by application of the equity method.
All available evidence should be considered in assessing whether a decline in value is other than temporary. The relative importance placed on individual facts may vary depending on the situation.

Factors to consider in assessing whether a decline in value is other than temporary include:

- The length of time (duration) and the extent (severity) to which the market value has been less than cost.
- The financial condition and near-term prospects of the investee, including any specific events which may influence the operations of the investee, such as changes in technology that impair the earnings potential of the investment or the discontinuance of a segment of the business that may affect the future earnings potential.
- The intent and ability of the investor to retain its investment in the investee for a period of time sufficient to allow for any anticipated recovery in market value.

Consideration should also be given to the reasons for the impairment and the period over which the investment is expected to recover. The longer the expected period of recovery, the stronger and more objective the positive evidence needs to be in order to overcome the presumption that the impairment is other than temporary. As the level of negative evidence grows, more positive evidence is needed to overcome the need for an impairment charge. The positive evidence should be verifiable and objective.

The following figures contain examples of negative evidence that may suggest that a decline in value is other than temporary.

**Figure 4-3**

Examples of negative evidence that could indicate decline is other than temporary

- A prolonged period during which the fair value of the security remains at a level below the investor’s cost
- The investee’s deteriorating financial condition and a decrease in the quality of the investee’s asset, without positive near-term prospects for recovery. For example, adverse changes in key ratios and/or factors, such as the current ratio, quick ratio, debt to equity ratio, the ratio of stockholders’ equity to assets, return on sales, and return on assets. With respect to financial institutions, examples of adverse changes are large increases in nonperforming loans, repossessed property, and loan charge-offs.
- The investee’s level of earnings or the quality of its assets is below that of the investee’s peers
- Severe losses sustained by the investee in the current year or in both current and prior years
- A reduction or cessation in the investee’s dividend payments
- A change in the economic or technological environment in which the investee operates that is expected to adversely affect the investee’s ability to achieve profitability in its operations
- Suspension of trading in the security
A qualification in the accountant’s report on the investee because of the investee’s liquidity or due to problems that jeopardize the investee’s ability to continue as a going concern

The investee’s announcement of adverse changes or events, such as changes in senior management, salary reductions and/or freezes, elimination of positions, sale of assets, or problems with equity investments

A downgrading of the investee’s debt rating

A weakening of the general market condition of either the geographic area or industry in which the investee operates, with no immediate prospect of recovery

Factors, such as an order or action by a regulator, that (1) require an investee to (a) reduce or scale back operations or, (b) dispose of significant assets, or (2) impair the investee’s ability to recover the carrying amount of assets

Unusual changes in reserves (such as loan losses, product liability, or litigation reserves), or inventory write-downs due to changes in market conditions for products

The investee loses a principal customer or supplier

Other factors that raise doubt about the investee’s ability to continue as a going concern, such as negative cash flows from operations, working-capital deficiencies, or noncompliance with statutory capital requirements

The investee records goodwill, intangible or long-lived asset impairment charges

The following figure contains examples of positive evidence that may suggest a decline in value is not other than temporary.

**Figure 4-4**
Positive evidence that could indicate decline is not other than temporary

Recoveries in fair value subsequent to the balance sheet date

The investee’s financial performance and near-term prospects (as indicated by factors such as earnings trends, dividend payments, analyst reports, asset quality, and specific events)

The financial condition and prospects for the investee’s geographic region and industry

In situations where the fair value is known, such as in the case of an investment with a quoted price or when an investee stock transaction occurs, and that fair value is below the investor’s carrying amount, the investor would need to assess whether that impairment is other than temporary. The fact that the fair value is below the carrying amount does not automatically require an impairment charge to be recognized. All facts and circumstances would need to be considered to determine if a decline is other than temporary.
Excerpt from ASC 323-10-35-32

A current fair value of an investment that is less than its carrying amount may indicate a loss in value of the investment. However, a decline in the quoted market price below the carrying amount or the existence of operating losses is not necessarily indicative of a loss in value that is other than temporary. All are factors that shall be evaluated.

For investments in private companies, information that would usually be considered includes:

- The price per share of the most recent round of equity investments
- The expected timing of the next round of financing
- The history of operating losses and negative cash flow
- Earnings and cash flow outlook and expected cash burn rate
- Technological feasibility of the company’s products

Once a determination is made that an OTTI exists, the investment should be written down to its fair value in accordance with ASC 820, which establishes a new cost basis. Therefore, the use of an “undiscounted cash flow” approach is not an appropriate means of assessing the value of an impairment charge. In addition, any bifurcation of declines in value between “temporary” and “other than temporary” is not allowed.

Fair value is determined at the reporting date for the purposes of an impairment. Therefore, subsequent declines or recoveries after the reporting date are not considered in the impairment that is recognized. A previously recognized OTTI also cannot subsequently be reversed when fair value is in excess of the carrying amount.

When an investor records an OTTI charge, the investor is required to attribute the impairment charge to the underlying equity method memo accounts of its investment. The attribution may create new basis differences, increase existing basis differences, or reduce existing basis differences. ASC 323 does not provide guidance on attributing the amount of an OTTI charge to the investor’s equity method memo accounts. We believe there are several acceptable methods to attribute the charge; however, the method applied should be reasonable given the nature of the OTTI charge. Acceptable methods include the specific identification method and the fair value method. Under the specific identification method, the investor would create a new basis difference or adjust an existing one for the specific items (e.g., litigation) that resulted in the OTTI charge. Under the fair value method, the investor would reset all its basis difference as if the investor had acquired the investment on the date of recording the OTTI charge. Example 4-37 illustrates the adjustment of an existing basis difference under the specific identification method.

**EXAMPLE 4-37**

Subsequent accounting for negative basis differences created by an impairment charge

In 20X0, Investor acquired a 40% investment in Investee (a public company) for $25 million. At the date of the acquisition, the book value of the net assets of Investee totaled $50 million and the fair value of the net assets totaled $62.5 million. The assets held by Investee consisted primarily of net
current assets with a carrying value and fair value of $30 million and long-lived assets with remaining useful lives of 10 years, a carrying value of $20 million, and a fair value of $32.5 million. As a result, the carrying value of Investor’s proportionate interest in the net assets of Investee was $20 million. The $5 million basis difference was attributed entirely to fixed assets.

Five years later (i.e., in year 20X5), Investee lost the contract of a significant customer and experienced some production issues. No impairment charge was recorded within Investee’s financial statements (impairment was tested under the long-lived asset impairment model using the undiscounted future cash flows, which were in excess of the book value of the assets). However, the market price per share of Investee declined below Investor’s investment balance per share, representing a potential impairment of $5 million. Based on all available information, Investor concluded that the decline in value of Investee’s market price per share was other than temporary. For simplicity, all tax implications are ignored.

How should Investor subsequently account for negative basis differences created by an impairment charge?

Analysis

Assuming Investor determines that the decline in value of $5 million is other than temporary, Investor would record an impairment charge of $5 million against the investment in Investee.

Given the nature of Investee’s operations and asset base (principally working capital and fixed assets), this loss would likely be considered attributable to Investee’s fixed assets. As a result, the impairment charge would eliminate the remaining fixed asset basis difference of $2.5 million ($5.0 million × 5/10 years amortized), and create an additional $2.5 million negative basis difference.

The negative basis differential would be amortized over the remaining asset lives. Investor would need to determine the amortization period. Although 5 years remain of the original 10-year life determined at acquisition, the remaining asset lives may not necessarily be 5 years. The estimated remaining lives of Investee’s fixed assets at the date of impairment would need to be considered in determining the appropriate amortization period. For purposes of this example, we have assumed 5 years.

Investee’s net income would include $2,000,000 of depreciation expense ($20,000,000 [investee’s carrying value of its fixed assets]/10 years [estimated useful life]), which reflects the carrying value of the fixed assets as reported in Investee’s financial statements. Investor would recognize its proportionate share of Investee’s net income; however, Investor should also amortize $500,000 ($2.5 million/5 years) of the negative basis difference as an increase (credit) to equity in earnings in order to reflect Investor’s lower cost basis in Investee’s fixed assets, which results in lower annual depreciation expense.

4.6.2 Impairments recorded at the investee level – investor accounting (equity method)

An investor applying the equity method does not need to separately test the investee’s underlying assets for impairment (or the value it has recorded in its equity method memo accounts related to those assets). Equity method goodwill is also not required to be separately assessed for impairment. ASC 350 indicates that the impairment guidance is not applicable to an investor applying the equity method on the basis that the investor does not control the business or underlying assets that give rise to the goodwill.
If the investee recognizes an impairment charge, including for goodwill, then the investor would generally need to record at least its share of that impairment charge. An impairment charge at the investee may also impact the investor's basis differences in those impaired assets.

As illustrated in Example 4-37, the investor and investee often apply different impairment models and at a different unit of account – impairment is tested at the investment level under the equity method versus at a lower level by the investee. Therefore, an impairment charge may need to be recorded at the investor level where no impairment exists at the investee level, or an impairment charge may need to be recorded at the investee level but not at the investor level.

### 4.7 Accounting for changes in interest in an equity method investment

An investor would continue to apply the equity method until its ownership interest is reduced or other changes are made such that the investor is no longer able to exert significant influence over the investee, or in the event that the investor gains a controlling financial interest over the investee. The reassessment of whether an investor has significant influence over the investee is an ongoing evaluation.

#### 4.7.1 Overview of changes in interest (equity method)

A change in ownership interest could cause an investment to either qualify for the equity method of accounting for the first time, continue to be accounted for as an equity method investment, or no longer qualify for the equity method. The following figure summarizes the accounting for changes in interests.

**Figure 4-5**

Summary of accounting for changes in interest

<table>
<thead>
<tr>
<th>Change in interest</th>
<th>Result</th>
<th>Impact to investor</th>
<th>Discussed in</th>
</tr>
</thead>
</table>
| **Fair value (or measurement alternative) to equity method** | Significant influence (control not obtained) – additional common stock and/or “in-substance” common stock investment. | Apply equity method prospectively to any previously held interest; may elect fair value option, which would also be applied prospectively. | Assuming fair value option not elected:  
- Determine basis differences for entire investment.  
- Recognize investment at investor’s current basis of previously held interests plus cost of incremental investment, if any. | CG 4.4 (and CG 4.4.5) |
| **Consolidate to equity method** | Loss of control but obtain/retain significant influence – due to sale or dilution of interest. | Cease consolidation accounting from date control is lost. Apply equity method prospectively; may elect fair value option. | Deconsolidate investment and remeasure retained investment (noncontrolling interest) at fair value. Gain or loss recognized in net income. Assuming fair value option not elected:  
- Retained investment (remeasured at fair value) forms initial cost basis of equity method | CG 4.4 |
<table>
<thead>
<tr>
<th>Change in interest</th>
<th>Result</th>
<th>Impact to investor</th>
<th>Discussed in</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Equity method to equity method (acquisition)</strong></td>
<td>Continue to have significant influence – common stock and/or “in-substance” common stock acquired.</td>
<td>Continue to apply equity method (assuming fair value option not previously elected).</td>
<td>Recognize cost for incremental investment (cost accumulation), determine basis differences arising on acquisition of new “step” interest using fair values of underlying investee assets and liabilities on the acquisition date.</td>
</tr>
<tr>
<td><strong>Equity to equity method (sale)</strong></td>
<td>Continue to have significant influence – common stock and/or “in-substance” common stock sold directly or through a dilution transaction.</td>
<td>Continue to apply equity method (assuming fair value option not previously elected).</td>
<td>Recognize gain or loss to the extent that the proceeds from the sale exceed or are less than the investor’s decrease in ownership interest in the underlying investee net assets plus the proportionate share of the unamortized balance of any basis differences.</td>
</tr>
<tr>
<td><strong>Equity method to consolidate</strong></td>
<td>Lose significant influence and gain control – common stock and/or “in-substance” common stock acquired.</td>
<td>Cease applying equity method and recognize gain or loss on remeasurement; consolidate as of date control is obtained.</td>
<td>Remeasure the previously held equity method investment (and any other previously held interests) at fair value and recognize any difference to the carrying amount in net income. Recognize 100% of identifiable assets and liabilities:</td>
</tr>
</tbody>
</table>

- Prospectively recognize investor’s share of equity investee’s earnings based on retained interest, adjusted for the effects of basis differences, and other items.
- □ Prospectively recognize investor’s share of equity investee’s earnings based on retained interest, adjusted for the effects of basis differences, and other items.
- □ Recognize the NCI in equity if less than 100% obtained.
- □ Recognize 100% of goodwill or bargain purchase gain.
Change in interest | Result | Impact to investor | Discussed in
--- | --- | --- | ---
**Equity method to fair value (or measurement alternative)** or no retained investment | Lose significant influence – common stock and/or “in-substance” common stock sold or through a dilution transaction | Cease applying equity method; apply other accounting to any retained interest | Recognize gain or loss to the extent that the proceeds from the sale exceed or are less than the investor’s ownership interest in the underlying investee net assets sold plus the proportionate share of the unamortized balance of any basis differences. The investor’s initial carrying amount of any retained common stock or “in-substance” common stock investment would include the proportionate share of previously recognized earnings or losses of the investee. | CG 4.7.3

1 For equity securities without readily determinable fair value, ASC 321 allows a measurement alternative defined as cost minus impairment, if any, plus or minus changes resulting from observable price changes.

2 Note that in some cases, an investor’s equity investment may in effect be diluted in an exchange transaction. In other cases, an investor’s equity investment may be exchanged for another equity method investment. See CG 4.4 for further discussion.

A change in the investor’s ownership interest can arise from transactions entered into by the investor (e.g., a purchase or sale of a portion of its interest), the investee (e.g., the investee issuing shares to select investors or upon exercise of employee stock options), or a combination thereof (e.g., the investee repurchases shares from investors not proportionate to their previous ownership interests). Investee issuances that cause an investor’s dilution can result in the investee’s receipt of cash or other consideration, including services or acquiring net assets (e.g., a business combination). The issuance of additional shares by the investee (including the exercise of employee stock options), which results in a decrease in ownership by the investor, has the same accounting effect as a direct sale of investee shares by the investor. Conversely, a repurchase of shares by the investee, which results in an increase in ownership by the investor, has the same accounting effect as a direct purchase of investee shares by the investor. See CG 4.7.4 for further information on the accounting for noncash transactions.

As discussed in ASC 323, the sale of investee shares by an investor generally results in gain or loss recognition.

**ASC 323-10-35-35**

Sales of stock of an investee by an investor shall be accounted for as gains or losses equal to the difference at the time of sale between the selling price and carrying amount of the stock sold.

For the purposes of calculating the gain or loss on the portion of the investment sold, the carrying amount of the stock sold would include a proportionate share of the investor’s basis differences.

Partnerships, and similar entities that maintain separate partnership (or members) accounts for each investor, generally specify that, at liquidation, cash is distributed in accordance with the balances in the investors’ capital accounts. Unless there are contractual provisions that provide for a reallocation of the capital contributed by the new investor to the investor’s capital account, a change of interest should generally not be recorded.

See PPE 5.5 for partial sales of in substance real estate.
4.7.2 **Reassessment of consolidation conclusion (equity method)**

An investor could gain or lose control in an investee entity for a number of reasons, including:

- A direct or indirect change in its level of ownership interest
- A change to a contractual arrangement or to the investee’s governing documents
- The expiration of a contractual relationship or the resolution of a contingency

An investor should no longer apply the equity method of accounting to an investee entity if it gains a controlling financial interest over the investee. The assessment of whether an investor has a controlling financial interest should be performed prior to applying the equity method of accounting.

Subsequently, an investor should reassess, on an ongoing basis, whether it has gained or lost a controlling financial interest in the investee. When an investor moves from the equity method to consolidation due to gaining a controlling financial interest in the investee through a business combination, consideration should be given to whether other transactions may be occurring at the same time as the business combination, such as the effective settlement of a preexisting relationship between the investee and investor. See BCG 2.7.2 for more information.

An investor may need to apply the equity method of accounting to an investee entity if it loses a controlling financial interest over the investee but retains a noncontrolling investment in common stock or in-substance common stock that gives it significant influence over that investee entity.

Change of interest transactions that result in the investor losing control generally result in the recognition of a gain or loss in net income for the sale of the interest and the remeasurement of any retained noncontrolling investment at fair value. If the investor has to apply the equity method, the fair value of the retained noncontrolling interest forms the basis for the initial measurement. Basis differences arise if the fair value of the investment differs from the investor’s proportionate share of the equity in the net assets of the investee.

When changing from consolidation to the equity method, the investee is consolidated until the point when control is lost and the equity method is applied from that point forward.

4.7.2.1 **Investee transactions (equity method)**

As previously noted, a change in interest can arise from an investee capital transaction such as due to the issuance or purchase of shares by the investee. A capital transaction by the investee generally has accounting implications for an investor as noted by the following guidance. These transactions are often referred to as “change of interest” transactions.

**ASC 323-10-35-15**

A transaction of an investee of a capital nature that affects the investor’s share of stockholders’ equity of the investee shall be accounted for on a step-by-step basis.

See CG 4.7.5 for further information on the concept of accounting for additional interests in an investee on a step-by-step basis.
Figure 4-6
Summary of the impact of transactions that result in change in ownership interest

<table>
<thead>
<tr>
<th>Situation</th>
<th>Investor accounting</th>
<th>Discussed in</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Investor buys additional shares from third parties</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>At over book value of investee</td>
<td>Acquisition</td>
<td>CG 4.7.5.1</td>
</tr>
<tr>
<td></td>
<td>accounting A</td>
<td></td>
</tr>
<tr>
<td>At under book value of investee</td>
<td>Acquisition</td>
<td>CG 4.7.5.1</td>
</tr>
<tr>
<td></td>
<td>accounting A</td>
<td></td>
</tr>
<tr>
<td><strong>Investor sells part of holdings to third parties</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Proceeds exceed carrying amount</td>
<td>Gain</td>
<td>CG 4.7.6</td>
</tr>
<tr>
<td>Carrying amount exceeds proceeds</td>
<td>Loss</td>
<td>CG 4.7.6</td>
</tr>
<tr>
<td><strong>Investee sells previously unissued shares</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><em>Investor buys no shares</em></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investee sells shares over carrying amount of investor</td>
<td>Gain</td>
<td>CG 4.7.6</td>
</tr>
<tr>
<td>Investee sells shares under carrying amount of investor</td>
<td>Loss</td>
<td>CG 4.7.6</td>
</tr>
<tr>
<td><em>Investor buys less than proportion formerly held</em></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investee sells shares over carrying amount of investor</td>
<td>Gain</td>
<td>CG 4.7.6.2</td>
</tr>
<tr>
<td>Investee sells shares under carrying amount of investor</td>
<td>Loss</td>
<td>CG 4.7.6.2</td>
</tr>
<tr>
<td><em>Investor buys more than proportion formerly held</em></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investee sells shares over book value of investee</td>
<td>Acquisition</td>
<td>CG 4.7.6.2</td>
</tr>
<tr>
<td></td>
<td>accounting A</td>
<td></td>
</tr>
<tr>
<td>Investee sells shares under book value of investee</td>
<td>Acquisition</td>
<td>CG 4.7.6.2</td>
</tr>
<tr>
<td></td>
<td>accounting A</td>
<td></td>
</tr>
<tr>
<td><strong>Investee buys shares to become treasury stock</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><em>Investor sells no shares</em></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investee buys shares over book value of investee</td>
<td>Acquisition</td>
<td>CG 4.7.5.3</td>
</tr>
<tr>
<td></td>
<td>accounting A</td>
<td></td>
</tr>
<tr>
<td>Investee buys shares under book value of investee</td>
<td>Acquisition</td>
<td>CG 4.7.5.3</td>
</tr>
<tr>
<td></td>
<td>accounting A</td>
<td></td>
</tr>
<tr>
<td><em>Investor sells less than proportion formerly held</em></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investee buys shares over book value of investee</td>
<td>Acquisition</td>
<td>CG 4.7.5.3</td>
</tr>
<tr>
<td></td>
<td>accounting A</td>
<td></td>
</tr>
<tr>
<td>Investee buys shares under book value of investee</td>
<td>Acquisition</td>
<td>CG 4.7.5.3</td>
</tr>
<tr>
<td></td>
<td>accounting A</td>
<td></td>
</tr>
</tbody>
</table>
The investor would apply acquisition accounting using the step-by-step acquisition model. The purchase price allocation would be recorded by the investor in its equity method memo accounts, which may include memo accounting goodwill. Goodwill is recognized only if the investee is a business.

In some cases, the sum of the amounts assigned to assets acquired and liabilities assumed will exceed the cost of the acquired investee interest (excess over cost). However, an investor should not recognize a bargain purchase gain (see CG 4.7.5 for further discussion).

### 4.7.3 Investment no longer qualifies for equity method

An investor could lose significant influence over the investee entity due to a change in its ownership interest. However, even without a change in ownership interest, an investor could lose significant influence, for example, due to a change in the investee’s governing documents. The reassessment of whether an investor has significant influence over the investee entity is an ongoing evaluation.

If an investor loses significant influence, whether it is due to a change in ownership interest or for other reasons, then the equity method of accounting should be discontinued. The investor would no longer accrue a share of earnings or losses of the investee from the point that significant influence is lost. Instead, the financial instruments guidance (e.g., ASC 320 or ASC 321) would apply to any remaining common stock or in-substance common stock investments in the investee. See LI 2 for further information.

### ASC 323-10-35-36

An investment in voting stock of an investee may fall below the level of ownership described in paragraph 323-10-15-3 from sale of a portion of an investment by the investor, sale of additional stock by an investee, or other transactions and the investor may thereby lose the ability to influence policy, as described in that paragraph. An investor shall discontinue accruing its share of the earnings or losses of the investee for an investment that no longer qualifies for the equity method. The earnings or losses that relate to the stock retained by the investor and that were previously accrued shall remain as a part of the carrying amount of the investment. The investment account shall not be adjusted retroactively under the conditions described in this paragraph. Topic 321 addresses the accounting for investments in equity securities that are not consolidated or accounted for under the equity method.

The following guidance addresses the accounting by the investor for its proportionate share of an investee’s OCI upon discontinuation of the equity method of accounting.
ASC 323-10-35-39

In the circumstances described in paragraph 323-10-35-37, an investor’s proportionate share of an investee’s equity adjustments for other comprehensive income shall be offset against the carrying value of the investment at the time significant influence is lost. To the extent that the offset results in a carrying value of the investment that is less than zero, an investor shall both:

a. Reduce the carrying value of the investment to zero
b. Record the remaining balance in income.

When an investment no longer qualifies for the equity method, the change to an investor’s accounting for its investment is applied prospectively. Any of the investee’s OCI recorded in the investor’s financial statements would be reclassified to the investor’s carrying value of its investment. Example 4-38 illustrates the determination of a gain or loss recognized by an investor upon a sale of a portion of its interest that results in a loss of significant influence.

EXAMPLE 4-38

Loss of significant influence

Investor owns 250,000 shares representing a 25% ownership interest in Investee, a public entity. Investor paid $25 million for the investment ($100 per share) and accounts for it under the equity method. No basis differences arose at the time of the acquisition and Investee’s net income has been break-even since.

In 20X0, Investee acquired a debt security that it accounted for as available for sale. Investee recognized a decrease in OCI of $10 million for the year due to a decline in the fair value of the security. Investor recorded its proportionate share of that decrease of $2.5 million (25% of the amount recorded within Investee’s OCI). As a result, the net carrying value of Investor’s investment in Investee at the end of the year was $22.5 million or $90 per share.

In 20X1, Investor sold 100,000 shares in Investee to an unrelated third party for $12 million. At the time of sale, the investee’s publicly traded share price was $120 per share. As a result of the sale, Investor’s ownership percentage decreased from 25% to 15% and it was determined to have lost significant influence. The tax impacts of the transaction have been ignored for simplicity.

What is the gain or loss recognized by Investor?

Analysis

Investor would need to recognize a gain on the sale, determined as follows:

<table>
<thead>
<tr>
<th>Shares</th>
<th>Book value per share</th>
<th>Book value (in 000’s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial investment</td>
<td>250,000</td>
<td>$100</td>
</tr>
<tr>
<td>Decrease in debt security value</td>
<td>(10)</td>
<td>(2,500)</td>
</tr>
<tr>
<td>Shares to sale</td>
<td>Book value per share</td>
<td>Book value (in 000’s)</td>
</tr>
<tr>
<td>---------------</td>
<td>----------------------</td>
<td>----------------------</td>
</tr>
<tr>
<td>250,000</td>
<td>$90</td>
<td>22,500</td>
</tr>
</tbody>
</table>

**Gain or loss calculation:**

<table>
<thead>
<tr>
<th>Sale of portion of investment</th>
<th>(100,000)</th>
<th>12,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: adjusted basis ($90 × 100,000)</td>
<td>(9,000)</td>
<td></td>
</tr>
<tr>
<td>Gain on sale of investment</td>
<td>$3,000</td>
<td></td>
</tr>
</tbody>
</table>

After the disposal, Investor’s net balance is $13.5 million ($22.5 million less the $9 million sold). In connection with the disposal, Investor should also release $1.0 million of the debit balance in AOCI (10/25 shares sold × $2.5 million), which will be presented as a reclassification adjustment. As a result, a debit balance would remain in AOCI of $1.5 million ($2.5 million less the $1.0 million sold).

Since the Investor has lost significant influence, the Investor should discontinue accruing its share of earnings/losses in Investee. Its remaining proportionate share of Investee’s AOCI should be reclassified to the carrying value of the investment. As a result, the $1.5 million balance in OCI would be reclassified as part of the investment balance of $13.5 million, resulting in a $15 million investment balance in Investee after the sale.

Finally, the Investor would mark its remaining investment to fair value in accordance with ASC 321, resulting in an additional gain of $3 million ((150,000 shares * $120) - $15 million).

The journal entries to reflect Investor’s accounting for these events would be as follows:

<table>
<thead>
<tr>
<th>Journal entries</th>
<th>20X0</th>
<th>20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr: Investment</td>
<td>$25m</td>
<td>Dr: Cash</td>
</tr>
<tr>
<td>Cr: Cash</td>
<td>$25m</td>
<td>Cr: Investment</td>
</tr>
</tbody>
</table>

*To record acquisition of investment*

| Dr: OCI | $2.5m |
| Cr: Investment | $2.5m |

*To record share of decline in fair value of debt security recorded by Investee in OCI (25% × $10m)*

| Dr: Realized gain/loss on sale | $1m |
| Cr: AOCI | $1m |

*To record sale of portion of investment*
Equity method of accounting

4.7.4 Noncash transactions (equity method)

Generally, the same guidance applies to noncash transactions as applies to cash transactions. Receipt or disbursement of noncash assets is just as effective in determining realization as is receipt or disbursement of cash in most circumstances.

An investor should apply the guidance in ASC 610-20 when it contributes nonfinancial assets that are not a business for an equity interest in an investee. See PPE 5.5 for guidance on the transfer of nonfinancial assets that are not a business in accordance with ASC 610-20.

4.7.5 Purchase of shares (equity method)

When an investor that applies the equity method acquires an additional investment, a separate analysis and assignment of excess cost should be made for that new investment as of the date the incremental investment is acquired. Therefore, if an investor is continuing to acquire additional interests from other investors in “steps,” a separate analysis and assignment of excess cost should be made as of the date each block is purchased (i.e., on a step-by-step basis). The previously held interests and related equity method memo accounts are not revisited on the purchase of each step as the equity method follows a cost accumulation methodology.

As previously discussed, each “step” is likely a triggering event to determine which consolidation model applies and may result in the investor obtaining a controlling financial interest.

A transaction by the investee that is of a capital nature may also result in an additional cost being assigned to net assets. For example, if an investee buys stock from some equity holders (not including the investor), the investor effectively acquires an additional interest in the investee and must recognize its share of the excess of cost over the investee’s book value, if any, as an additional cost of the acquired net assets of the investee in its equity method memo accounts.

If an investor, that holds common stock in the investee and is able to exercise significant influence over the investee, acquires in-substance common stock of the investee, then the equity method would typically apply to that additional interest. Similarly, if an investor is able to exercise significant influence through its in-substance common stock investment and acquires common stock in the investee, the equity method would also typically apply to the additional common stock investment.

The additional cost element should be assigned to individual assets and liabilities, taking into account (a) the difference between their fair values and book values at the date of the transaction and (b) the

<table>
<thead>
<tr>
<th>Transaction Description</th>
<th>Dr</th>
<th>Cr</th>
</tr>
</thead>
<tbody>
<tr>
<td>To record recycling of portion of AOCI balance ((10/25)*$2.5m)</td>
<td>Investment $1.5m</td>
<td>AOCI $1.5m</td>
</tr>
<tr>
<td>To record reclassification of remaining AOCI balance on loss of significant influence</td>
<td>Investment $3.0m</td>
<td>Gain $3.0m</td>
</tr>
<tr>
<td>To mark the investment to its fair value</td>
<td>Investment</td>
<td>Gain</td>
</tr>
</tbody>
</table>
proportionate increase in the investor's ownership interest as a result of the purchase of treasury shares by the investee.

In some cases, the sum of the amounts assigned to assets acquired and liabilities assumed will exceed the cost of the acquired entity (excess over cost). The concept of a bargain purchase gain does not apply to the equity method of accounting since the investor does not control the underlying assets of the investee and, therefore, would not be able to realize a gain by selling any of the individual investee assets. In addition, an investor would record an equity method investment based on the accumulated cost of acquiring the investment (rather than the fair value basis) as required in a business combination. Therefore, a basis difference for any excess over cost would generally be allocated as a pro-rata reduction (on a fair value basis) of the amounts that otherwise would have been assigned to the acquired noncurrent assets. See CG 4.4.5.3 for further information.

4.7.5.1 **Purchase of shares from third parties (equity method)**

Incremental purchases of common stock or in-substance common stock from third parties are recorded at cost. There will generally be a difference between the investor’s cost and the investor’s acquired percentage ownership in the underlying equity in net assets of the investee at the date of an investment.

Consistent with the initial application of the equity method, the incremental basis difference must be analyzed and assigned first to identifiable tangible and intangible assets and liabilities generally based on their fair values at the date of the purchase of the additional interest. Any unassigned difference would be designated as equity method goodwill in the equity method memo accounts.

4.7.5.2 **Investee sells additional shares and investor is net purchaser (equity method)**

When the investee sells additional shares of its stock and the investor buys a greater proportion of the shares offered than its pre-sale proportionate ownership, the investor is a “net purchaser” as its post-transaction percentage ownership interest is increased. The effect of these transactions from an investor point of view is a purchase of additional shares at a cost more or less than investee book value. The investor would account for the net effect of the purchase in the same manner as if the shares were acquired from a third party.

4.7.5.3 **Investee purchases shares and investor is net purchaser (equity method)**

When an investee buys treasury stock and the investor does not sell shares, the investor is a “net purchaser” as its ownership interest in the investee is increased. This transaction is effectively an indirect acquisition by the investor, and is similar to when an investor acquires shares of the investee directly from other investors. Therefore, the accounting is the same whether the actual outlay of cash is made by the investor or the investee.

The economic substance of this transaction is that assets of the investee have been disbursed to buy an outside interest, thus increasing the investor’s ownership interest while reducing the investor’s proportionate share of the investee’s net assets. While the investor’s investment balance will not change, the investee’s purchase gives rise to an adjustment of the basis of the investor’s share of net assets of the investee (i.e., a difference to be assigned first to tangible and identifiable intangible assets and liabilities, with any remaining difference to goodwill). This allocation will not impact the investor’s investment balance for an equity method investment. Accordingly, the allocation is only recorded in the investor’s equity method memo accounts of the equity method investment.
In some cases, when an investee buys treasury stock and the investor sells less than the proportion formerly held, the investor’s ownership interest in the investee increases. This transaction is effectively an indirect acquisition by the investor. Cash proceeds received from the investee would reduce the investor’s investment balance and the investor would be required to account for basis differences resulting from the investee’s purchase of treasury stock in the same manner described above.

When the investee buys shares at more than book value, the investor loses equity to the extent of its share (ownership interest after repurchase) of the total decrease in book value of the investee attributable to the repurchase from third parties. Example 4-39 illustrates such a transaction.

**EXAMPLE 4-39**

**Investor is net purchaser due to investee transaction**

Investor owns 40 common shares in Investee representing a 40% ownership interest (a total of 100 shares are outstanding). The carrying value of the investment on Investor’s books is $10 per share, which is also Investee’s book value per share (i.e., no basis differences exist). Investee subsequently purchases 25 shares from third parties at $12 per share in a treasury stock transaction. The price exceeds Investee’s book value per share of $10.

As a result of this transaction, Investor’s ownership interest in Investee has increased from 40% to 53.3% (or 40 shares/75 shares). Investor, in not selling any of its ownership interest has, in substance, purchased an additional interest in Investee. Assume Investor does not obtain control of Investee.

What entries should Investor and Investee record?

**Analysis**

Investor would record $27 in its equity method memo accounts, the difference between its investment carrying amount of $400 and its underlying equity in Investee’s net assets of $373 (53.3% × $700 [Investee’s initial net assets of $1,000 less the $300 paid by Investee to purchase 25 shares from third parties at $12 per share]) arising from Investor not participating in Investee’s treasury stock transaction and, therefore, not maintaining its proportionate interest in Investee. This could also be calculated as the investor’s share (post-transaction) of the decrease in book value attributable to the repurchase of the shares from third parties ($2 per share × 25 shares × 53.3%). Investor’s loss of equity of $27 due to the change of interest should be allocated to assets and liabilities with the excess being recorded as goodwill.

As illustrated below, the investor’s investment balance remains the same ($400). The investor would have to reallocate its investment balance between its original acquisition (40%) and the current acquisition (13.3%).
### Investor

<table>
<thead>
<tr>
<th></th>
<th>Before transaction</th>
<th>Transaction entries</th>
<th>After transaction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percentage interest</td>
<td>40%</td>
<td></td>
<td>53.3%</td>
</tr>
<tr>
<td>Investment in equity method investee</td>
<td>$400</td>
<td></td>
<td>$400</td>
</tr>
<tr>
<td>Change of interest</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity in net assets</td>
<td>400</td>
<td>(27)</td>
<td>373</td>
</tr>
<tr>
<td>Goodwill</td>
<td></td>
<td>27</td>
<td>B 27</td>
</tr>
<tr>
<td>Total investment</td>
<td>400</td>
<td></td>
<td>400</td>
</tr>
<tr>
<td>Other assets</td>
<td>2,600</td>
<td></td>
<td>2,600</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>$3,000</td>
</tr>
<tr>
<td>Liabilities</td>
<td></td>
<td>($1,000)</td>
<td>($1,000)</td>
</tr>
<tr>
<td>Common stock</td>
<td>(500)</td>
<td></td>
<td>(500)</td>
</tr>
<tr>
<td>Paid-in capital</td>
<td>(500)</td>
<td></td>
<td>(500)</td>
</tr>
<tr>
<td>Retained earnings:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Beginning</td>
<td>(1,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net income</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ending</td>
<td>(1,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shareholders' equity</td>
<td>(2,000)</td>
<td></td>
<td>(2,000)</td>
</tr>
<tr>
<td></td>
<td>($3,000)</td>
<td></td>
<td>($3,000)</td>
</tr>
</tbody>
</table>

### Investee

<table>
<thead>
<tr>
<th></th>
<th>Before transaction</th>
<th>Transaction entries</th>
<th>After transaction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>$2,000</td>
<td>($300) A</td>
<td>$1,700</td>
</tr>
<tr>
<td>Liabilities</td>
<td>(1,000)</td>
<td></td>
<td>(1,000)</td>
</tr>
<tr>
<td>Net assets</td>
<td>$1,000</td>
<td>($300)</td>
<td>$700</td>
</tr>
<tr>
<td>Common stock:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investor</td>
<td>($200)</td>
<td></td>
<td>($200)</td>
</tr>
<tr>
<td>Third parties</td>
<td>(300)</td>
<td>$125 A</td>
<td>(175)</td>
</tr>
<tr>
<td>Paid-in capital:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investor</td>
<td>(80)</td>
<td></td>
<td>(80)</td>
</tr>
<tr>
<td>Third parties</td>
<td>(120)</td>
<td>50 A</td>
<td>(70)</td>
</tr>
<tr>
<td>Retained earnings:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investor-at acquisition</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investor-since acquisition</td>
<td>(120)</td>
<td>27 B</td>
<td>(93)</td>
</tr>
</tbody>
</table>
### 4.7.6 Sale of shares (equity method)

An investor that applies the equity method may sell all or a portion of its interest in the investee to a third party. For such transactions, investor should recognize a gain or loss equal to the difference between the selling price and the carrying value of the interest sold at the time of sale.

When an investee sells additional shares and investor purchases no shares, or purchases less than the proportion formerly held, the investor’s ownership interest in the investee decreases. Such a transaction is effectively an indirect disposal of part of the investor’s ownership interest in investee.

The investor should recognize a gain or loss equal to the difference between the selling price per share and the investor’s carrying amount per share. Other investee transactions that may trigger a gain or loss for the investor are discussed in CG 4.7.6.1 and CG 4.7.6.2.

In determining the gain or loss in a partial disposition of an equity method investment, the carrying amount of shares sold should generally be calculated based on the average carrying amount of all shares held by the investor. Other methods have been applied in practice, such as the “identified certificate” or FIFO basis; however, the average carrying amount will often best reflect the economic substance of the disposition. For example, under the "identified certificate" method, the gain or loss on disposition will be impacted by the specific certificates that are selected for sale; therefore, this method is not often considered an appropriate method. It should also be noted that a temporary difference arises when the “identified certificate” or FIFO basis is used to compute taxable income and the average basis is used to determine the gain or loss for financial reporting.

#### 4.7.6.1 Investee purchases shares and investor is net seller (equity method)

When the investee offers to purchase shares from all or some investors in a treasury stock transaction and the investor sells a proportion greater than its pre-transaction ownership interest, the investor is a “net seller” as its percentage ownership interest in the investee is decreased (i.e., investor effectively sells part of its ownership interest in the investee).
A gain or loss would be recognized to the extent that the proceeds from the sale exceed or are less than the investor’s loss of equity in the underlying investee net assets plus the proportionate share of the unamortized balance of any excess cost assigned to identifiable assets and goodwill.

4.7.6.2 Investee sells previously unissued shares and investor is a net seller (equity method)

When the investee sells additional shares of its stock, the investor may purchase some or all of the shares offered. If the investor does not buy sufficient shares to maintain its proportionate interest, the investor is a “net seller” as it has effectively disposed of part of its investment. Similarly, if the investee sells additional shares to parties other than the investor then the investor’s percentage ownership in the investee decreases.

A gain or loss on disposal would generally be recorded in the event that the selling price per share is more or less than the investor’s average carrying amount per share. No new basis differences would arise. Basis differences generally only arise on the acquisition of an interest in an investee.

Example 4-40 illustrates a transaction where the investee issues previously unissued shares at over book value while the investor does not buy any additional shares.

EXAMPLE 4-40
Investor is a net seller in investee transaction

Investor owns 40 common shares in Investee representing a 40% ownership interest (a total of 100 shares are outstanding). The carrying value of the investment on Investor’s books is $10 per share, which is also Investee’s book value per share (i.e., no basis differences exist). Investee subsequently issues 25 shares at $20 to third parties. This price exceeds Investee’s book value per share of $10.

As a result of this transaction, Investor’s ownership interest in Investee has declined from 40% to 32% (or 40 shares/125 shares).

What entries should Investor and Investee record?

Analysis

Investor should record the gain arising from the sale of shares by Investee to third parties at a price in excess of the per share carrying value of the shares owned by Investor. When an investor does not participate in a new issue offered for sale by the investee at over book value, it gains equity in the investee net assets to the extent of its share (ownership interest after offering) of the excess over book value of investee capital paid in by third parties. This is calculated as the investor’s share (post-transaction) of the increase in book value attributable to the issuance of the shares to third parties ($10 per share * 25 shares * 32%). Investor, in having its ownership interest reduced from 40% to 32%, has, in substance, sold a part of its interest in Investee. In this example, Investor’s carrying amount is equal to Investee’s book value. If they were not equal, a pro rata write-off would be required of any unamortized difference between Investor’s cost and Investor’s equity in Investee’s net assets.
The accounting entry for this example is illustrated as follows:

<table>
<thead>
<tr>
<th>Journal entry</th>
<th>Before transaction</th>
<th>Transaction entries</th>
<th>After transaction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr: Investment</td>
<td>$80</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cr: Realized gain on sale</td>
<td>$80</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*To record sale of portion of investment*

<table>
<thead>
<tr>
<th>Investor</th>
<th>Before transaction</th>
<th>Transaction entries</th>
<th>After transaction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percentage interest</td>
<td>40%</td>
<td>32%</td>
<td></td>
</tr>
<tr>
<td>Investment in equity method investee</td>
<td>$400</td>
<td>$400</td>
<td></td>
</tr>
<tr>
<td>Change of interest</td>
<td>80</td>
<td>B, C</td>
<td>80</td>
</tr>
<tr>
<td>Equity in net assets</td>
<td>400</td>
<td>80</td>
<td>480</td>
</tr>
<tr>
<td>Goodwill</td>
<td>-</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total investment</td>
<td>400</td>
<td>80</td>
<td>480</td>
</tr>
<tr>
<td>Other assets</td>
<td>2,600</td>
<td>2,600</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$3,000</td>
<td>$80</td>
<td>$3,080</td>
</tr>
<tr>
<td>Liabilities</td>
<td>($1,000)</td>
<td>($1,000)</td>
<td></td>
</tr>
<tr>
<td>Common stock</td>
<td>(500)</td>
<td>(500)</td>
<td></td>
</tr>
<tr>
<td>Paid-in capital</td>
<td>(500)</td>
<td>(500)</td>
<td></td>
</tr>
<tr>
<td>Retained earnings:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Beginning</td>
<td>(1,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net income</td>
<td></td>
<td>$24</td>
<td>B</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(104)</td>
<td>C</td>
</tr>
<tr>
<td>Ending</td>
<td></td>
<td>(1,080)</td>
<td></td>
</tr>
<tr>
<td>Shareholders’ equity</td>
<td>(2,000)</td>
<td>(80)</td>
<td>(2,080)</td>
</tr>
<tr>
<td></td>
<td>($3,000)</td>
<td>($80)</td>
<td>($3,080)</td>
</tr>
</tbody>
</table>

| Investee | | | |
| Assets | $2,000 | $500 | A | $2,500 |
### Equity method of accounting

**Before transaction** | **Transaction entries** | **After transaction**
--- | --- | ---
Liabilities | (1,000) | (1,000) |  
Net assets | $1,000 | $500 | $1,500

**Common stock:**

<p>| | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Investor</td>
<td>($200)</td>
<td></td>
<td>($200)</td>
</tr>
<tr>
<td>Third parties</td>
<td>(300)</td>
<td>(125)</td>
<td>A</td>
</tr>
</tbody>
</table>

**Paid-in capital:**

<p>| | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Investor</td>
<td>(80)</td>
<td>(104)</td>
<td>C</td>
</tr>
<tr>
<td>Third parties</td>
<td>(120)</td>
<td>(375)</td>
<td>A</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>104</td>
</tr>
</tbody>
</table>

**Retained earnings:**

<p>| | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Investor-at acquisition</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investor-since acquisition</td>
<td>(120)</td>
<td>24</td>
<td>B</td>
</tr>
<tr>
<td>Third parties</td>
<td>(180)</td>
<td>(24)</td>
<td>B</td>
</tr>
</tbody>
</table>

**Shareholders’ equity**

<p>| | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>($1,000)</td>
<td>($500)</td>
<td>($1,500)</td>
</tr>
</tbody>
</table>

**A -** Record sale to third parties of 25 shares at $20 each for cash

**B -** Adjustment to record change of Investor’s share of undistributed investee earnings as follows:

- Before transaction (40% of $300) $120
- After transaction (32% of $300) (96)
- Decrease in Investor’s share of undistributed investee earnings $24

**C -** Adjustment to record change of interest in Investee’s paid-in capital computed as follows:

- Investor’s post-transaction share of Investee’s net assets (32% of $1,500) ($480)
- Investor’s cost ($280) and post-transaction share of Investee’s undistributed earnings ($96) 376
- Excess of cost and share of undistributed earnings since acquisition over equity in net assets (vice versa) ($104)

When the investee issues additional shares as a result of the exercise of employee stock options, the dilution gain/loss should be calculated similar to Example 4-40. However, the consideration received for the shares issued upon exercise includes any previously recognized compensation expense plus cash proceeds upon exercise (i.e., exercise price multiplied by the number of shares).
Gain or loss calculation on investee transactions (equity method)

An investor may sell a portion of an equity method investment to the investee in an investee treasury stock transaction. The gain or loss recognized by the investor is equal to the difference between (1) the proceeds attributable to the stock sold and (2) the loss of equity in the underlying investee’s net assets, including, if applicable, a proportionate share of the unamortized balance of any excess cost assigned to identifiable assets and goodwill. Example 4-41 illustrates the determination of an investor’s gain or loss from an investee treasury stock transaction.

**EXAMPLE 4-41**

Gain or loss calculation in an investee treasury stock transaction

Investor A owns 200 common shares representing a 50% ownership interest in Investee and accounts for its investment under the equity method of accounting. The common shares have an aggregate carrying value on the books of Investor A of $600 and a fair value of $800. Investors B and C are the other investors in Investee, each owning 25% of the outstanding common shares of Investee.

Investor A agrees to sell 50% of its holding in Investee, or 100 shares (with a fair value of $400), to Investee that will be accounted for as a treasury stock transaction in Investee’s financial statements. Assume Investor A has no basis differences between the carrying amount of its investment and its underlying equity in Investee’s net assets.

Immediately prior to the sale by Investor A, the shareholdings of Investee can be summarized as follows:

<table>
<thead>
<tr>
<th>Shareholding</th>
<th>Fair value</th>
<th>Book value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investor A</td>
<td>200 shares (50%)</td>
<td>$800</td>
</tr>
<tr>
<td>Investor B</td>
<td>100 shares (25%)</td>
<td>400</td>
</tr>
<tr>
<td>Investor C</td>
<td>100 shares (25%)</td>
<td>400</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$1,600</strong></td>
<td><strong>$1,200</strong></td>
</tr>
</tbody>
</table>

After the sale, Investors A, B, and C each own 100 shares in Investee, resulting in each having a 33% ownership interest. Investor A’s ownership interest effectively declined from 50% to 33% (a decline of 34% or 17%/50%). Investors B and C have effectively increased their respective ownership interest from 25% to 33%. However, Investee’s net assets have also declined as it paid Investor A $400 to complete the transaction.

What is Investor A’s gain on the sale of its shares?

**Analysis**

The gain or loss is equal to the difference between the cash received by Investor A ($400) and the adjustment necessary to the carrying amount of Investor A’s investment in Investee (ensuring that no new basis differences are being established due to Investor A’s sale) to reflect its share of the net assets after the transaction ($336 = Investor A’s original investment basis in Investee of $600 – Investor A’s investment basis in Investee after the transaction of $264 (33% × $800)). Therefore, the gain or loss in this example is $64 ($400 - $336).
Another way to determine or prove the gain or loss calculated above would be to consider a portion of the $400 payment to Investor A as reflecting a distribution of net assets that Investor A effectively already owned. Said differently, Investee is deemed to have distributed $200 to Investor A, and $100 each to Investor B and C. Investors B and C in effect then each used their $100 distributions to purchase a portion of Investor A’s ownership interest.

Therefore, the proceeds received by Investor A on the sale of its ownership interest is $200 (not $400 since $200 was a return of a proportionate share of net assets). After the return of the proportionate share of net assets, the carrying value of Investor A’s interest has been reduced to $400. For each investor to have a one-third interest in the Investee, Investor A would need to sell 33 shares for $100 to each of Investors B and C representing 34% or $136 of Investor A’s basis. The gain on sale recognized by Investor A as a result of the transaction would be $64 ($200 - $136).

The aforementioned steps are summarized as follows:

<table>
<thead>
<tr>
<th>Investee</th>
<th>Investor A</th>
<th>Investors B and C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net assets</td>
<td>Owner-ship</td>
<td>Cash</td>
</tr>
<tr>
<td>Prior to transaction</td>
<td>$1,200</td>
<td>50%</td>
</tr>
<tr>
<td>Step 1: Deemed distribution</td>
<td>(400)</td>
<td>—</td>
</tr>
<tr>
<td>Subtotal</td>
<td>800</td>
<td>50%</td>
</tr>
<tr>
<td>Step 2: Investors B and C purchase 34% of Investor A’s interest (17% of the entity)</td>
<td>—</td>
<td>(17%)</td>
</tr>
<tr>
<td>Total</td>
<td>$800</td>
<td>33%</td>
</tr>
</tbody>
</table>

If part of the $400 received by Investor A was not viewed as a return of a proportionate share of net assets, Investor A would have overstated its profit on the sale ($400 - $300 = $100 versus $64), and new basis differences would have been created. That is because the carrying value of Investor A’s retained interest of $300 would no longer reflect its proportionate share of the net assets of Investee ($264 or 33% of $800) after the acquisition.

As illustrated above, the calculation of the “shift in equity” arising from investee capital transactions is relatively easy when the investor carries its pre-transaction investment at an amount equal to its equity in the underlying investee net assets, because the shift in equity may be determined directly by reference to the change in the investor’s share of net assets reported in the investee financial statements.

On the other hand, when the investment is carried in the financial statements of the investor at an amount that is more or less than the investor’s equity in underlying investee net assets, care must be exercised to take into account a proportionate share of the unamortized basis difference between the investment carrying amount and the investor’s share of investee net assets in computing the gain or loss to be recognized in income. Example 4-42 illustrates the determination of a gain or loss when an investor is a net seller in an investee transaction.
EXAMPLE 4-42

Investor is a net seller in an investee transaction

Investor owns 40% (40 of 100 outstanding shares) of Investee and has an investment basis of $500. Investee has 100 shares outstanding and equity of $1,000 or $10 per share. The carrying amount of Investor’s investment of $500 exceeds its 40% share of Investee’s net assets by $100 (Investor’s 40% of Investee’s net assets of $1,000 is a $400 share of investee net assets). The excess of $100 has been assigned to fixed assets ($60) and goodwill ($40).

Investee sells 25 newly issued shares for $500 or $20 per share. Investor buys no shares and therefore its ownership interest declines from 40% to 32% (40 shares/125 shares).

How should Investor account for the sale?

Analysis

Investor’s gain would be computed as follows:

\[
\text{Increase in investor’s share of Investee’s net assets (40 shares/125 shares \times $1,500 = $480 less 40/100 \times $1,000 = $400)} \quad $80
\]

Less pro rata write-off of unamortized difference between Investor’s cost and Investor’s equity in Investee’s net assets: $100 \times 20%  \quad (20)

Change of interest gain  \quad $60

The adjustment of the unamortized excess cost should be applied (generally pro rata) to the unamortized components of the difference. Thus, in the above example, the $20 would be applied as follows to Investor’s equity method memo accounts:

<table>
<thead>
<tr>
<th>Excess assigned to:</th>
<th>Before</th>
<th>Pro rata adjustment</th>
<th>Pro rata percentage</th>
<th>After</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed assets</td>
<td>$60</td>
<td>$12</td>
<td>60%</td>
<td>$48</td>
</tr>
<tr>
<td>Goodwill</td>
<td>40</td>
<td>8</td>
<td>40%</td>
<td>32</td>
</tr>
</tbody>
</table>

|                     | $100   | $20                 |                     | $80   |

Investor would continue to amortize the adjusted amounts of fixed assets prospectively over appropriate remaining periods. Goodwill is not amortized assuming the PCC alternative is not elected.

4.7.6.4 Gain or loss calculation on sale of in-substance common stock (equity method)

A gain or loss could also be recognized by the investor when it is a seller or net-seller of in-substance common stock. This treatment is considered acceptable because the in-substance common stock is determined to have risks and reward characteristics that are substantially the same as the entity’s common stock.
Gains and losses arising from investee transactions of a capital nature are not currently taxable events. Deferred taxes will have to be provided for the entire difference between the book and tax basis in the investment including the portion that results from a change in interest gain for all investees unless:

- the entity is a foreign subsidiary or a foreign corporate joint venture that is essentially permanent in duration; or
- an entity is a domestic subsidiary for which the basis difference is a permanent difference rather than a temporary difference.

If deferred taxes are provided on a change of interest gain reflected as a credit to investor paid-in capital, intraperiod tax allocation must be followed. See TX 11 for further information.

4.7.7 Investee transactions that do not result in a change in interest (equity method)

A pro rata distribution of shares by an investee to shareholders (e.g., in a spin-off or other form of reorganization or liquidation), should be accounted for as a deemed distribution to shareholders at the carrying amount of the investment. That is, an investor who receives the distribution would allocate its previous investment in the spinnor between the spinnor and the shares received in the spin-off.

A non-pro rata disposition of shares by an investee (e.g., a split-off) may give rise to a gain or loss to an investor that is a net seller. That gain or loss would be equal to the difference between the fair value of the investment received at the date of exchange and its carrying amount of its proportionate share of its investment in investee that was sold including, if applicable, a proportionate share of the unamortized balance of any excess cost assigned to identifiable assets and goodwill.

4.7.8 Subsequent investment after suspension of equity method losses

An investor could make a subsequent investment in an investee after having suspended the recognition of its share of the losses of the investee. The question then arises whether this should be accounted for as an additional investment or treated as a funding of previous losses. The following guidance addresses this situation:

ASC 323-10-35-29

If a subsequent investment in an investee does not result in the ownership interest increasing from one of significant influence to one of control and, in whole or in part, represents, in substance, the funding of prior losses, the investor should recognize previously suspended losses only up to the amount of the additional investment determined to represent the funding of prior losses (see (b)). Whether the investment represents the funding of prior losses, however, depends on the facts and circumstances. Judgment is required in determining whether prior losses are being funded and all available information should be considered in performing the related analysis. All of the following factors shall be considered; however, no one factor shall be considered presumptive or determinative:

a. Whether the additional investment is acquired from a third party or directly from the investee. If the additional investment is purchased from a third party and the investee does not obtain additional funds either from the investor or the third party, it is unlikely that, in the absence of other factors, prior losses are being funded.
b. The fair value of the consideration received in relation to the value of the consideration paid for the additional investment. For example, if the fair value of the consideration received is less than the fair value of the consideration paid, it may indicate that prior losses are being funded to the extent that there is disparity in the value of the exchange.

c. Whether the additional investment results in an increase in ownership percentage of the investee. If the investment is made directly with the investee, the investor shall consider the form of the investment and whether other investors are making simultaneous investments proportionate to their interests. Investments made without a corresponding increase in ownership or other interests, or a pro rata equity investment made by all existing investors, may indicate that prior losses are being funded.

d. The seniority of the additional investment relative to existing equity of the investee. An investment in an instrument that is subordinate to other equity of the investee may indicate that prior losses are being funded.

**ASC 323-10-35-30**

Upon making the additional investment, the investor should evaluate whether it has become otherwise committed to provide financial support to the investee.

### 4.7.9 Investee transactions with noncontrolling interest holders (equity method)

An investee may have a wholly owned subsidiary and decide to sell a noncontrolling interest in the subsidiary to third parties. Similarly, an investee may have a partially owned subsidiary and decide to sell an additional noncontrolling interest in the subsidiary to third parties, or acquire some or all of the existing noncontrolling interest from the noncontrolling interest holders. From the investee’s perspective, these transactions are considered equity transactions and are accounted for in accordance with ASC 810, as the investee continues to have a controlling financial interest in the subsidiaries. The accounting standards do not provide guidance on how the investor should account for these transactions.

Depending on whether the investee is selling or acquiring a noncontrolling interest in its subsidiary, we believe an investor may choose to account for these transactions using one of several alternatives.

If the investee sells a noncontrolling interest in its subsidiary, we believe the investor may account for the transaction using one of the following methods.

- The investor may account for the transaction as if the investor had sold a portion of its investment, similar to a dilution gain or loss, and record the gain or loss in its income statement. This method follows the guidance in ASC 323-10-40-1 on how an investor records a dilution gain or loss for its equity method investment when the investee issues additional shares to another party. Under this method, the investor has sold a portion of its investment in the investee even though its ownership percentage has not changed. This method is similar to the indirect sale approach when an investee sells shares to other investors and the investor has a decrease in its ownership percentage in the investee. See CG 4.7.6.2.

- The investor may also account for the transaction as an equity transaction and record its portion of the investee’s equity transaction directly to its additional paid in capital. This method follows the guidance in ASC 323-10-35-15 on how an investor should record its portion of an investee’s equity transaction in a similar manner.
If the investee acquires a noncontrolling interest in its subsidiary, we believe the investor may account for the transaction using one of the following methods.

- The investor may account for the transaction as if the investor had acquired an additional interest in the investee similar to a step acquisition. This method follows the guidance in ASC 323-10-35-33 on how an investor records a step acquisition for its equity method investment. Under this method, the investor has effectively acquired an additional interest in the investee even though its ownership percentage has not changed. This method is similar to the step acquisition approach when an investee acquires shares from the other investors (treasury stock transaction) and the investor has an increase in its ownership percentage in the investee. See CG 4.7.5.3. This method will likely result in the investor having to account for new or additional basis differences in its memo accounts.

- The investor may also account for the transaction as an equity transaction and record its portion of the investee’s equity transaction directly to its additional paid in capital. This method follows the guidance in ASC 323-10-35-15 on how an investor should record its portion of an investee’s equity transaction in a similar manner.

### 4.8 Low income housing tax credit partnerships (equity method)

Many companies, particularly financial institutions, invest in limited partnerships or similar limited liability companies that operate qualified affordable housing projects or invest in one or more other entities that operate qualified affordable housing projects. These investors earn federal tax credits as the principle return for providing capital to facilitate the development, construction, and rehabilitation of low-income rental property. Investors in these entities may be eligible, subject to meeting a number of criteria, to elect to recognize the return they receive as a component of income taxes in the income statement.

In order to be eligible for the election, one criterion requires that the investor not have the ability to exercise significant influence over the operating and financial policies of the entity. This criterion is evaluated using the indicators of significant influence for determining eligibility for the equity method of accounting previously discussed (see CG 4.3.2). However, the general presumptions on voting stock ownership levels (see CG 4.3.1) are not applicable for this evaluation. Therefore, care should be taken when evaluating the existence of significant influence for these entities.

An investor may conclude that it does not have significant influence based on the indicators for evaluating low income housing tax credit partnerships. However, the equity method of accounting may still need to be applied if the investor does not elect, or is not within the scope, of that guidance. Typically, the equity method is applied to investments in limited partnership entities of more than 3 to 5%. 


Chapter 5: Joint ventures
5.1 Chapter overview

Joint ventures are popular structures for creating alliances and gaining entry to or expanding business operations in various domestic and foreign markets. Joint ventures may be accounted for differently than other similarly structured transactions and joint arrangements. Therefore, it is important to properly distinguish arrangements that meet the accounting definition of a joint venture. Also, because of the lack of definitive, authoritative accounting literature addressing joint venture agreements, and the potentially conflicting accounting guidance often referred to by analogy (e.g., ASC 805, Business Combinations, ASC 718, Compensation — Stock Compensation, ASC 845, Nonmonetary Transactions, and ASC 970, Real Estate), accounting for joint ventures requires careful analysis and judgment. Furthermore, in some cases, arrangements may be referred to as joint ventures even though they do not meet the accounting definition of a joint venture. In other cases, a joint venture may be a VIE (refer to CG 2) and one investor, or another enterprise with a variable interest in the entity, may be the primary beneficiary required to consolidate the joint venture, in which case it does not meet the joint control requirements for joint venture accounting. In connection with the accounting for joint ventures, two of the most significant and difficult issues are (1) the investor’s/venturer’s accounting for the formation of the joint venture (specifically, whether a gain or loss can be recognized at formation for the contribution to the joint venture of noncash assets) and (2) accounting by the joint venture for the receipt of noncash assets at formation.

This chapter discusses the definition of a joint venture and the accounting for the initial investment(s) at formation by both the investor and the joint venture. Subsequent to the formation of a joint venture, there is no unique or specific accounting model for either the investor or the joint venture. That is, an investor generally applies the equity method of accounting for its investment, which is described in CG 4, and the joint venture applies the relevant GAAP standards for its transactions just as any other operating entity.

5.2 Identifying a joint venture

In practice, the term “joint venture” is usually referred to rather loosely. Structures or transactions that are not joint ventures for accounting purposes are commonly called joint ventures.

A corporate joint venture is defined as follows.

Definition from ASC 323-10-20

Corporate joint venture: A corporation 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. A government may also be a member 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.
This definition does not include investments in unincorporated joint ventures (including partnerships), although ASC 323-30 concludes that many of the provisions of ASC 323 are also appropriate in assessing investments in unincorporated joint ventures. Therefore, in practice, a joint venture is not restricted by the type or legal form of the entity. Joint venture accounting does not apply to arrangements between entities under common control.

5.2.1 Joint control

The most distinctive characteristic of a joint venture is the concept of joint control. An AcSEC Issue Paper, which is not authoritative guidance, describes the concept of joint control in its definition of a joint venture. This definition and the concept of joint control are widely applied in practice.

**Definition from AcSEC Issue Paper, Joint Venture Accounting (7/17/79), Paragraph 51(b)**

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

This definition establishes joint control over the decision-making process as the most significant attribute of joint ventures, regardless of the form of legal ownership or voting interest held. That is, the type of legal entity (e.g., corporation, partnership) is not relevant as long as the entity’s governing documents provide for each venturer to exercise joint control. There is a distinction between “joint control over decision making” and a structure in which no single party has “control” over decision making. The latter does not meet the definition of a joint venture as all investors need not agree in order to approve an entity’s action.

Joint control exists when the investors are able to participate in all of the significant decisions of an entity. An understanding of the governance structure of the entity is necessary to determine whether there is joint control over the significant decisions of the venture by all venturers. At times, power over the significant decisions of the entity may rest with the board of directors, however, the rights of all venturers should be considered in making the assessment as to whether joint control exists. The venturers, therefore, at a minimum, must be able to effectively participate in those significant decisions through substantive veto or approval rights. To be substantive, these rights must have no significant barriers to exercise (i.e., significant penalties or other hurdles making it difficult or unlikely they could be exercised).

Joint control can still exist when public shareholders own interests in a joint venture. The definition of a joint venture indicates that, while stock of a joint venture is usually not traded publicly, a noncontrolling interest held by public ownership does not preclude a corporation from being a corporate joint venture. In the unusual instance where the public has an equity interest in a joint venture, that interest is usually small relative to the other venturers’ interests and does not provide the public shareholders with a means to actively participate in all significant decision-making of the joint
venture. In such cases, joint control can still exist if control rests jointly with the venturers excluding the public shareholders.

Given that joint control requires unanimous consent over all significant decisions by all the venturers, it is not uncommon for venturers to disagree on certain significant decisions. In these cases, it is important to understand how disagreements are resolved. Sometimes, when the venturers cannot agree, no action is approved and no further action on that issue is taken by the venturers or venture. Other times, the dispute may go to arbitration for resolution. Settlement of disputes through arbitration does not preclude the investors from having joint control; however, if one investor has tie-breaking authority in the event of a dispute, joint control does not exist.

Some investors may also have unilateral control over decisions that are not significant to the joint venture's operations (e.g., selecting the auditor of the joint venture). Because these decisions are considered protective rather than participating, joint control over these decisions is not required. In these cases, the venturers would still be deemed to have joint control over the significant decisions.

Question 5-1, Question 5-2, and Question 5-3 discuss joint ventures that have more than two venturers. Question 5-4 addresses whether all venturers are required to have an equal ownership interest in the joint venture.

**Question 5-1**
Can a joint venture have more than two venturers?

**PwC response**
Yes, provided the joint venture satisfies all of the requirements in the definition of a joint venture, including the requirement for joint control by all venturers. Thus, each venturer in the joint venture would need to participate in the joint control over the joint venture.

**Question 5-2**
Assume three investors create a new entity, with each investor owning one-third of the equity of the new entity, and each having one-third of the investor votes. Investor approval over significant decisions of the new entity requires a simple majority of the investor votes. Does this qualify as joint control?

**PwC response**
No, although no investor controls the entity, a majority vote in this case means that only two of the three investors are needed to make the significant decisions of the new entity. This does not meet the concept of joint control. However, joint control would exist if investor approval over significant decisions required a unanimous decision by all three investors.
Question 5-3

Assume three investors create a new entity, with each investor owning one-third of the equity and significant decisions require unanimous approval of all three investors. If the investors cannot agree on a decision within 30 days after the initial disagreement, an independent arbitrator will be engaged to resolve the issue within 25 business days once engaged. Does this qualify as joint control?

PwC response

Yes, joint control exists as investor approval over significant decisions requires a unanimous vote of all investors. The use of an arbitrator to aid in the resolution of a potential disagreement does not negate the joint control terms as stipulated in the joint venture agreement. The arbitrator is only engaged and used when there is a disagreement among the three investors and generally would not be making the significant decisions on an ongoing basis.

Question 5-4

Are all venturers required to have an equal ownership interest in the joint venture (e.g., are two venturers in a joint venture required to each have a 50% ownership interest in the joint venture)?

PwC response

No, the definition of a joint venture does not require that each investor have an equal ownership interest in the joint venture. However, care should be exercised when evaluating a joint venture when there is not equal ownership among the investors as that might indicate the venture does not meet the definition of a joint venture (e.g., there may be a lack of joint control among the venturers). For instance, significant differences in ownership interests among investors may raise questions as to why an investor with proportionately greater economic interest would permit lower economic interest investors to have the same level of participation over the significant decisions of the entity.

5.2.2 Other characteristics

In addition to joint control, there are other characteristics that must be met in order for an entity to meet the definition of a joint venture, as described in ASC 323-10-20. That is, joint control alone is not sufficient to obtain joint venture accounting. At the 2014 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff stated that each of the characteristics in the definition of a joint venture should be met for an entity to be a joint venture, including that the purpose of the entity is consistent with that of a joint venture.

The importance of the other characteristics of a joint venture is also discussed in ASC 845-10-S99-2, which states that the existence of joint control is not the only defining characteristic when determining whether an entity is a joint venture, rather, the other characteristics of a joint venture also need to be present. While the other characteristics might appear to be broad in nature and lacking of specific guidance on how an entity would meet them (versus, for example, the joint control characteristic), an entity should exercise care and reasonable judgment in assessing whether it has met the additional characteristics. In making this assessment, the factors to consider include, among other things, the purpose, nature, and operations of the entity. Understanding the type of investors may also help with this assessment.
For example, if the substance of a transaction is primarily to combine two or more existing operating businesses, which are either separate subsidiaries or divisions of a larger company, in an effort to generate synergies such as economics of scale or cost reductions and/or to generate future growth opportunities, such a transaction may be considered a merger that should be accounted for as a business combination under ASC 805 rather than as a joint venture. In this fact pattern, determining whether the purpose of the transaction is consistent with the definition of a joint venture as described in ASC 323 requires significant judgment.

Example 5-1 through Example 5-4 illustrate some of the accounting considerations when evaluating whether an entity meets the definition of a joint venture for accounting purposes.

**EXAMPLE 5-1**

Determining whether a joint venture is formed when each investor contributes its entire operations to a new entity

Company A, a holding company, owns Company B, which has a fair value of $500 million, and represents all of Company A’s operations. Company C, a holding company, owns Company D, which has a fair value of $400 million, and represents all of Company C’s operations. Company A and Company C agree to combine their operating businesses in a newly established entity, Newco. Company A contributes Company B in exchange for 55% equity and joint control of Newco. Company C contributes Company D in exchange for 45% equity and joint control of Newco. Company A and Company C each has two members on the four member board of directors and unanimous approval from all board members is required for all decisions related to Newco. Other than joint control, none of the other characteristics of a joint venture as described in ASC 323 exist.

Does this arrangement meet the definition of a joint venture for accounting purposes?

*Analysis*

No. Newco does not meet the definition of a joint venture. Although the investors appear to have joint control, both investors have contributed their entire operations, and therefore would likely not meet the aspect of the definition that describes the purpose of a joint venture.

**EXAMPLE 5-2**

Determining whether a joint venture is formed when one investor contributes a business and the other investor contributes cash to a new entity

Company A, a holding company, owns various businesses including Company B, which has a fair value of $500 million. Company A and Company C agree to form a joint venture, Newco, as they have plans for new product offerings and expansion into new markets. Company A contributes Company B in exchange for 50% equity and joint control of Newco. Company C contributes $500 million cash in exchange for 50% equity and joint control of Newco. The cash will remain in Newco to be used for ongoing operating expenses, developing new products, and developing new production facilities. Company A and Company C each has two members on the four member board of directors and unanimous approval from all board members is required for all decisions related to Newco.

Does this arrangement meet the definition of a joint venture for accounting purposes?
Analysis

Yes. Newco meets the definition of a joint venture for accounting purposes. Company A and Company C have each made contributions in exchange for joint control of the new entity. The purpose for the entity is consistent with that of a joint venture as the venture will use the cash invested by Company C to gain access to new markets and to develop new products.

**EXAMPLE 5-3**

Whether a joint venture is formed when one investor sells 50% of an existing operating subsidiary

Company A, a holding company, owns Company B, which has a fair value of $500 million, and represents all of Company A’s operations. Company A has decided to cash out a portion of its existing business. To facilitate the transaction, Company A and Company C agree to form a new company, Newco, which the two investors will jointly own and jointly control. Company A contributes Company B in exchange for 100% of the equity of Newco. Company C pays $250 million cash to Company A in exchange for 50% of its equity in Newco. Company A and Company C each has two members on the four member board of directors and unanimous approval from all board members is required for all decisions related to Newco.

Does this arrangement meet the definition of a joint venture for accounting purposes?

Analysis

No. While the investors have joint control over Newco, the substance of the transaction is that Company A has sold 50% of its business in exchange for cash. As the purpose of the transaction does not meet any of the other characteristics as described in ASC 323-10-20, this arrangement does not meet the definition of a joint venture for accounting purposes.

**EXAMPLE 5-4**

A joint venture structured in the form of a partnership

Company A and Company B form a new venture, Newco Partnership, a limited partnership. The general partner (GP) of Newco Partnership is Company C Corporation, a newly formed entity jointly owned and controlled by Company A and Company B. Company A owns 100% of Company A LLC, which has a 40% limited partnership interest in Newco Partnership. Company B owns 100% of Company B LLC, which has a 40% limited partnership interest in Newco Partnership. The GP owns the remaining 20% general partnership interest in Newco Partnership. The GP has the unilateral right to make all the decisions of Newco Partnership and the LPs do not have any participating rights or kick-out rights. Company A and Company B are not related parties.
Does Newco Partnership meet the definition of a joint venture?

**Analysis**

Yes. Assuming all of the other characteristics in ASC 323-10-20 are met, Newco Partnership would meet the definition of an accounting joint venture since Company A and Company B have joint control over the GP, which controls Newco Partnership. In this case, the substance of the arrangement is that the two companies have joint control over the joint venture.

**5.2.3 Applying the VIE Model to joint ventures**

At the formation of the joint venture (or when an investor becomes involved with or acquires an interest in a joint venture), an investor in the joint venture is required to first determine if the joint venture entity is a VIE. If the entity is a VIE and is required to be consolidated by one of the investors, it would not meet the definition of a joint venture. On the other hand, if the entity is a VIE but no party is required to consolidate it (including after giving effect to any related party considerations), the entity may meet the definition of a joint venture. An entity that is a VIE and meets the definition of a joint venture would be considered an entity where power is shared among its equity investors, with no investor consolidating the joint venture.

ASC 810-10 provides for a scope exception from the application of the VIE model to a joint venture if the joint venture is a business and certain conditions are met. The scope exception is primarily an investor exception (versus an entity exception). Thus, each investor in the joint venture will have to assess whether it qualifies for the scope exception. One investor in the joint venture may qualify while another investor may not. The application of the scope exception necessitates thoughtful judgment and consideration. Due to the characteristics of many joint ventures, qualification for the scope exception is expected to be infrequent, so investors will generally have to apply the VIE guidance to joint ventures.

An investor in a joint venture that initially meets the requirements for the scope exception should continually reassess that it qualifies for the scope exception. If an investor in a joint venture no longer meets the requirements for the scope exception, the VIE model would be applied prospectively.

There is no investor scope exception from the application of the VIE guidance to a joint venture if the joint venture is not a business.
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 GAAP should be applied):

1. The reporting entity, its related parties, 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.

While none of the conditions noted above can exist in order for an investor in a joint venture to qualify for the scope exception, conditions 2 and 3 described in 810-10-15-17(d)(2) and 810-10-15-17(d)(3), respectively, generally prevent an investor from applying the business scope exception to a joint venture.

**Condition 2: The “substantially all” test**

An understanding of the purpose and design of the entity is required in order to evaluate whether substantially all of its activities either involve or are conducted on behalf of the reporting entity and its related parties. Generally, investors form a joint venture for a specific purpose that will benefit all of the investors; therefore, the activities of the joint venture typically involve or are conducted on behalf of the investors and not substantially all for one investor. However, given that many joint ventures only have two (or a few) investors, it is not unusual for the activities of a joint venture to be substantially all on behalf of one of the investors. We believe the assessment of the substantially all criteria is primarily qualitative, and that the phrase “substantially all” does not indicate a quantitative economic guideline. See CG 2.1.2.4 for additional guidance.

**Condition 3: Subordinated financial support**

Most variable interests in an entity are considered subordinated financial support. As a result, this scope exception would generally be available only when it is obvious that the investor would not absorb the majority of the economics of the entity on a fair value basis. For many 50:50 joint venture arrangements, it will be difficult to make this assertion. In a 50:50 joint venture, while the economics are intended to be shared on a 50:50 basis, in practice this may not be the case. There are often commercial arrangements between the investors and the joint venture that may be variable interests and it becomes difficult to establish that the economics with respect to all the variable interests held by
the investors are shared equally. Therefore, the entity will very likely need to be evaluated under the VIE model. See CG 2.1.2.4 for additional guidance.

Example 5-5 and Example 5-6 illustrate the application of the business scope exception guidance in ASC 810-10-15-17(d)(2) and (3).

**EXAMPLE 5-5**

Determining whether an investor in a joint venture can apply the business scope exception in ASC 810-10-15-17(d)

Company A and Company B form a joint venture, Newco. Company A contributes one of its subsidiaries, a business with a fair value of $100 million, in exchange for 50% of the equity of Newco. Company B contributes $100 million cash in exchange for 50% of the equity of Newco. The cash contributed by Company B will remain in Newco for operating expenses to develop new products and markets. Newco, which is deemed to be a business, was created so that all of its activities are conducted on behalf of Company A. Newco sells all of its output to Company A and all of Newco’s employees are seconded from Company A. Newco obtains a $120 million, six year, fixed 5% rate loan from a bank, which is guaranteed by both Company A and Company B.

Company A and Company B each has two members on the four member board of directors of Newco and unanimous approval from all board members is required for all decisions related to Newco. The investors concluded that Newco meets the definition of a joint venture.

Does Company A qualify for the business scope exception in ASC 810-10-15-17(d)?

**Analysis**

No. Newco is deemed to be a business and Newco meets the definition of a joint venture as discussed in CG 5.2.1. However, given that Newco sells all of its output to Company A and Company A provides all the employees of Newco, all of the activities of Newco are deemed to be conducted on behalf of Company A. Therefore, the business scope exception is not available to Company A as the condition in ASC 810-10-15-17(d)(2) exists. Company A would need to evaluate its investment in Newco under the VIE model. Refer to CG 2.3 for additional guidance.

**EXAMPLE 5-6**

Determining whether an investor in a joint venture can apply the business scope exception in ASC 810-10-15-17(d)

Company A and Company B form a joint venture, Newco, for the purpose of developing new products and access new markets. Company A contributes cash in exchange for 50% of the equity of Newco, and Company B contributes a division of its operations (that constitutes a business) in exchange for 50% of the equity of Newco. Company B also provides a loan to Newco to fund its working capital requirements.

Company A and Company B each has two of the total four board seats of Newco and unanimous approval from all board members is required for all decisions related to Newco.

Does Company B qualify for the business scope exception in ASC 810-10-15-17(d)?
**Analysis**

No. Newco is deemed to be a business and Newco also meets the definition of a joint venture as discussed in CG 5.2.1. However, Company B is providing more than half of the total subordinated financial support to Newco through its 50% equity interest and the working capital loan to Newco. Therefore, the business scope exception is not available to Company B as the condition in ASC810-10-15-17(d)(3) exists. Company B would need to evaluate its investment in Newco under the VIE model. Refer to CG 2.3 for additional guidance.

**5.2.4 Joint venture vs collaborative arrangements**

Investors may enter into arrangements that are considered collaborative arrangements rather than joint ventures for accounting purposes. A collaborative arrangement is a series of contracts between two or more parties that involves a joint operating activity, as described in ASC 808. It can be used for a particular purpose (e.g., marketing products) and in many cases does not include a joint ownership in assets. Such arrangements are not joint ventures. See CG 6.3 for discussion of collaborative arrangements.

**5.3 Accounting for the joint venture by the investor**

Once it has been determined that a joint venture should not be consolidated pursuant to ASC 810, an investment in a joint venture is generally accounted for under the equity method of accounting pursuant to ASC 323.

When an investor contributes a business, or a group of assets that represents a business, to a joint venture, the investment is generally recorded at fair value, as described in CG 5.3.1.1. Similarly, when an investor contributes nonfinancial assets that do not represent a business to a joint venture, the investment is generally recorded at fair value, as discussed in CG 5.3.1.2.

In some cases, an investor may elect the fair value option to account for its investment in a joint venture, or it may meet the requirements for proportionate consolidation, which are both discussed in CG 5.3.2.

**5.3.1 Investor accounting for an investment in a JV at formation**

ASC 323 provides guidance regarding the initial measurement of an investment in a joint venture as follows.

**ASC 323-10-30-2**

Except as provided in the following sentence, an investor shall measure an investment in common stock of an investee (including a joint venture) initially at cost in accordance with the guidance in Section 805-50-30. An investor shall initially measure, at fair value, the following:

a. A retained investment in the common stock of an investee (including a joint venture) in a deconsolidation transaction in accordance with paragraphs 810-10-40-3A through 40-5.
b. An investment in the common stock of an investee (including a joint venture) recognized upon the derecognition of a distinct nonfinancial asset or distinct in substance nonfinancial asset in accordance with Subtopic 610-20.

5.3.1 Contribution of a business

ASC 805 defines a business as follows.

**Definition from ASC 805-10-55-3A**
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.

See BCG 1 and ASC 805-10 for further information on what constitutes a business.

When an investor contributes a subsidiary or group of assets that constitute a business to a joint venture, the investor should apply the deconsolidation and derecognition guidance in ASC 810-10-40 and record any consideration received for its contribution at fair value (including its interest in the joint venture). This generally results in a gain or loss on the contribution.

**Excerpt from ASC 810-10-40-5**
A parent shall account for the deconsolidation of a subsidiary or derecognition of a group of assets specified in paragraph 810-10-40-3A by recognizing a gain or loss in net income attributable to the parent, measured as the difference between:

a. The aggregate of all of the following:

1. The fair value of any consideration received

2. The fair value of any retained noncontrolling investment in the former subsidiary or group of assets at the date the subsidiary is deconsolidated or the group of assets is derecognized

3. The carrying amount of any noncontrolling interest in the former subsidiary at the date the subsidiary is deconsolidated.

b. The carrying amount of the former subsidiary’s assets and liabilities or the carrying amount of the group of assets.

This guidance does not apply if the investor’s contribution is a conveyance of oil and gas mineral rights. An investor would apply the guidance in ASC 932 to account for these types of contributions to the joint venture.

Example 5-7 illustrates the accounting considerations when an investor contributes a business to a joint venture. See BCG 5.5 for examples of the accounting by an investor upon deconsolidation of a business.
EXAMPLE 5-7
Investor accounting for a contribution of a business to a joint venture

Company A has three reporting units, X, Y, and Z. Business B is one of several businesses within Company A’s reporting unit X. Company A previously assigned goodwill from a prior acquisition to reporting unit X. Company A has entered into an agreement with an unrelated third party to form a 50:50 joint venture, Newco, and will contribute Business B to Newco. Assume Newco meets the definition of a joint venture, does not qualify as a variable interest entity under ASC 810-10, and will be accounted for as an equity investment in the financial statements of Company A under ASC 323.

How should Company A account for its investment in Newco?

Analysis

The guidance in ASC 810-10 should be followed when a subsidiary that is a business is transferred to a joint venture. Therefore, Company A should realize a gain or loss following the guidance in ASC 810-10-40-5. The carrying amount of Business B should include an allocation of reporting unit X’s goodwill following the guidance in ASC 350-20-35-51 as the contribution of a business to a joint venture is analogous to other disposals (e.g., a sale, abandonment, spin-off).

The gain/loss would consist of two parts, the realized gain/loss on the effective sale of the 50% interest in Business B to the unrelated third party, and the unrealized gain/loss from the remeasurement to fair value of the 50% noncontrolling investment effectively retained in Business B.

5.3.1.2 Contribution of assets that do not represent a business

An investor may contribute a subsidiary or group of assets that are nonfinancial assets or in substance nonfinancial assets and also not a business to a joint venture. In these cases, the investor should record its joint venture investment in accordance with ASC 323-10-30-2 and ASC 610-20 (provided other guidance is not applicable, e.g., ASC 860, ASC 932). See PPE 5.5 for guidance on the derecognition of nonfinancial assets and in substance nonfinancial assets.

5.3.1.3 Contribution of services to a noncustomer

A gain should not be recognized on receipt of an interest in a joint venture if some or all of the investor’s interest was received for future services to be rendered, as this implies continuing involvement through a future obligation.

5.3.2 Other investor accounting methods

5.3.2.1 Fair value option

ASC 825-10-15-4 permits an investor to elect the fair value option to account for its investment in a joint venture. If the investor applies the fair value option to a joint venture that would otherwise be accounted for under the equity method of accounting, the investor should also apply the fair value option to all of the investor’s financial interests in the joint venture (e.g., equity and debt, including guarantees) as further discussed in ASC 825-10-25-7(b).
5.3.2.2 *Proportionate consolidation*

Proportionate consolidation is appropriate only in limited circumstances and in certain industries. There is a longstanding practice in the construction and extractive industries of investors displaying investments in separate unincorporated legal entities (versus an investment in an incorporated entity or an undivided interest in the separate assets and liabilities) accounted for using the equity method of accounting on a proportionate gross basis, such that the investor’s financial statements reflect the investor’s pro rata share of each of the venture’s assets, liabilities, revenues, and expenses (rather than the one-line treatment) consistent with the guidance in ASC 810-10-45-14. See CG 6.4 for further details.

5.3.2.3 *Fair value method*

The definition of a joint venture requires that the investor have the ability to participate in the management of the joint venture; therefore the fair value method in accordance with ASC 321 is generally not used to account for an investment in a joint venture. However, the fair value method may be appropriate in situations where an investee is in legal reorganization or in bankruptcy, or operates under foreign exchange restrictions, controls, or other governmentally imposed restrictions so severe that they cast significant doubt on the investor’s ability to exert significant influence over the investee.

5.3.3 *Restructuring and impairment charges*

When joint ventures are created by contributing assets and/or businesses from existing entities, certain restructuring and impairment charges are often anticipated. For example, there may be plans to close certain operating plants or reduce personnel. Such restructurings and impairments are typically an integral part of the negotiations between the venture partners. See PPE 6 for a discussion of impairment under ASC 360-10 and ASC 420, *Exit or Disposal Cost Obligations*.

Question 5-5 discusses the accounting by an investor that contributes a facility (e.g., a plant) expected to be shut down at or shortly after formation of the joint venture.

**Question 5-5**

If an investor contributes a plant that is expected to be shut down at or shortly after formation of the joint venture, should expenses associated with shutting down the plant be recognized by the investor?

**PwC response**

Determining whether the investor or joint venture should bear the cost if restructuring activities related to assets being contributed to a joint venture are initiated in anticipation of the formation of the joint venture and in agreement with the other joint venture partner requires significant judgment. An assessment should be made to determine whether the restructuring costs are more appropriately the responsibility of the investor or the joint venture.

An impairment of assets that would otherwise be required under generally accepted accounting principles cannot be avoided by contributing the assets to a joint venture as discussed in “Loss recognition” in CG 5.3.1.2. This would apply, for example, to lower of cost or market write-downs for inventory or impairments of long-lived assets as required by the guidance in ASC 360-10.
If after formation, the joint venture decides to restructure operations of the contributed plant and such restructuring was not contemplated in the joint venture formation, the restructuring costs should be recognized in the accounts of the joint venture.

5.3.4 Start-up and organization costs

Costs incurred by an investor directly related to the organization of a joint venture should be expensed as incurred in accordance with ASC 720-15-25-4, as they are considered akin to start-up costs incurred in the formation of a new entity.

5.3.5 Cumulative translation adjustment accounts

An investor may decide to contribute a portion or all of its foreign operations that constitute a business to a joint venture. This would result in the investor deconsolidating a portion or all of its foreign operations. In these cases, the investor needs to determine whether its investment in the joint venture results in a deconsolidation event within a foreign entity or a deconsolidation event of a foreign entity, as described in ASC 830-10. If it is deemed a deconsolidation event within a foreign entity, the investor would not release any of its cumulative translation adjustments (“CTA”) into earnings unless such deconsolidation event represents a complete or substantially complete liquidation of the foreign entity. In contrast, if it is deemed a deconsolidation event of a foreign entity, the investor would release all of its CTAs related to the derecognized foreign entity, even when a noncontrolling investment is retained. Refer to FX 8 for additional information regarding this determination.

5.3.6 Tax basis differences

Sometimes an investor may recognize its investment in a joint venture at fair value, while for tax purposes its investment in the joint venture was not deemed to be a taxable transaction. This would result in a difference in the book and tax basis of the investment. Refer to TX 11 for further details regarding the impact to the investor when tax basis differences exist.

5.4 Accounting by the joint venture

The guidance in this section applies only to entities that meet the definition of a joint venture as discussed in CG 5.1. Generally, the most significant accounting issue the joint venture will need to address is the amount at which to record noncash capital contributions received from its investors. There is little authoritative guidance on accounting by a joint venture for contributed nonmonetary assets.

5.4.1 Initial contributions to the joint venture

Generally, noncash contributions to a joint venture are recognized by the joint venture at the lower of the investor’s carryover basis or fair value.

Prior to the issuance of ASC 810, Consolidation and ASC 610-20, Gains and losses from the derecognition of nonfinancial assets, both the investor (venturer) and the joint venture applied carryover basis when recognizing transactions involving the exchange of noncash assets for equity at formation, except in certain limited circumstances. The issuance of ASC 810 and more recently ASC 610-20 changed the accounting by the investor. Because the exchange of a business for a noncontrolling equity investment results in a loss of control over the business, ASC 810 acknowledges that this is a significant economic realization event that changes the nature of the retained
noncontrolling investment. As a result, as discussed in CG 5.3, investors that transfer a subsidiary (or a group of assets) meeting the definition of a business generally recognize the initial equity investment at fair value. Similarly, ASC 610-20 requires the investor to record its investment in the joint venture at fair value when contributing nonfinancial assets or in substance nonfinancial assets that do not meet the definition of a business to the joint venture.

The resulting asymmetry in accounting basis between the investor and the joint venture created by ASC 810 and ASC 610-20 evoked a debate about whether it may be appropriate for the joint venture to also record the contributed business or nonfinancial assets at fair value. Given the changes to the investor’s accounting models, recent statements made by the standard setters have indicated that there may be instances when it may be appropriate to accept contributions being recorded at fair value at the joint venture level. More guidance may be issued in the future.

5.4.1.1 SEC registrant joint ventures

The SEC staff has historically taken the view that the joint venture can elect to record the investor’s contributions at fair value only when all of the following conditions are met:

- Noncash assets are contributed by an investor into a newly formed venture and, after the transaction, the investor does not control the venture.
- The other investor contributes cash in an amount equal to the fair value of the noncash assets (fair value must be objectively determinable) contributed by the first venturer, and such cash remains in the joint venture or is used by the joint venture in transactions with parties other than the venturers.
- The investors have joint control over the joint venture.
- The investors are unaffiliated.
- Neither investor in the joint venture has preference in the allocation of equity or profits or losses (i.e., the profit split conforms to the ownership arrangement).

The SEC staff has also stated that a partial step-up in basis (to the extent that property has been “acquired” by the investor contributing cash) may be permitted in the following circumstances:

- Investor B acquires for cash a one-half interest in certain assets directly from Investor A. Both investors then contribute their interests in the assets to a new entity. Assume the new entity meets the definition of a joint venture as described in ASC 323-10-20.

- Investor A contributes certain assets to a new entity. Investor B acquires for cash a one-half interest in the new entity directly from Investor A. Assume the new entity meets the definition of a joint venture as described in ASC 323-10-20. (In the SEC staff’s view, this transaction is, in substance, the same as the first transaction and should be accounted for in a consistent manner.)

In both of the above transactions, the contributed property would be recorded on the books of the joint venture at 50% carrying value (Investor A’s carrying basis) and 50% fair value (Investor B’s carrying basis). A 100% step-up in basis to fair value has historically not been permitted, since cash was not contributed to the venture. A partial step-up would also be permitted in a scenario economically
similar to the second circumstance above, but where Investor B contributes cash into the joint venture and the cash is then distributed from the joint venture to Investor A.

The SEC staff has indicated that in certain limited circumstances, an investor’s contribution of recently acquired property from an independent third party could serve to validate the fair value of the other investor’s contributions and justify recording the joint venture’s assets at fair value.

The SEC staff has also stated that application of the above accounting guidelines to a joint venture with other than equal ownership (but joint control) would have to be evaluated on a case-by-case basis.

Example 5-8 illustrates joint venture accounting for tangible and intangible assets received upon formation of the venture.

**EXAMPLE 5-8**

**Joint venture accounting for tangible and intangible assets received upon formation of the venture**

Company A and Company B are unaffiliated entities that form an SEC-registered joint venture. Each investor has a 50% equity interest and joint control over the joint venture. Company A contributes a business from one of its divisions that has a net carrying value of $5 million and a fair value of $10 million. The $10 million includes $9 million for tangible assets and $1 million for identifiable intangible assets. Company B contributes $10 million in cash that will remain in the joint venture to fund operating expenses. The venture meets the other characteristics of a joint venture.

How should the contributed assets be recorded by the joint venture?

**Analysis**

Since the joint venture has met the SEC’s conditions for recognizing the contributions at fair value as described above, the joint venture may elect to record total assets of $20 million — $10 million in cash, $9 million for tangible assets, and $1 million for the identifiable intangible assets. The joint venture may also record total assets of $15 million — $10 million in cash and $5 million for the business, since carryover basis is an acceptable measurement method upon formation of a joint venture.

Regardless of how the joint venture accounts for the contribution, Company A would record a gain upon losing control of a previously consolidated business following the guidance in ASC 810-10-40-5.

**Non-registrant joint ventures**

Given the lack of guidance for the accounting for contributions received by a joint venture, entities generally look to the SEC guidance discussed in CG 5.4.1.1 in determining when fair value would be appropriate at the joint venture level.

Recording the investor contributions at carrying value in the nonregistrant joint venture financial statements continues to be appropriate, especially in the following scenarios:

- Noncash assets are contributed whose fair value is not readily determinable with a high degree of reliability, which may be the case when all investors contribute noncash assets.
Noncash assets are contributed for which the recoverability of their fair value is in doubt. For example, internally developed intangible assets contributed to a joint venture will often be recorded at the investor’s basis (usually zero).

### 5.4.2 Tax basis differences

Noncash assets contributed to a joint venture that are recorded at fair value by the joint venture may have a lower tax basis that carries over from the investor to the venture. In these situations, the different bases of the assets for book vs. tax purposes would be a temporary difference for which deferred taxes should be recorded by the joint venture at the date of contribution, if the joint venture is a taxable entity. Refer to TX 11 for further information.

### 5.4.3 Conforming accounting policies

At its inception, the joint venture establishes its own accounting policies. Typically, these are selected from those of the investors. Adoption of these accounting policies is not considered a change in the joint venture’s accounting policies under ASC 250-10 and SEC Regulation S-X 10-01; rather, it represents the initial selection by the joint venture of its own accounting policies. As a result, the investor and joint venture may have different accounting policies for similar items. Generally, no associated adjustment is required to be made in the investor’s financial statements when recognizing its equity method investment in the joint venture, except with regard to inter-company items, such as the elimination of inter-company profit and loss. Refer to CG 4.5.2 for further details.

A non-public joint venture may follow certain accounting alternatives promulgated by the FASB through the Private Company Council (the PCC Accounting Alternatives). If a joint venture applies the PCC Accounting Alternatives in its financial statements, a public registrant investor in the joint venture would have to reverse the effects when reflecting the results of its equity method investment in the joint venture. Refer to CG 4.5.6.4 for further details.

### 5.5 Dissolution of a joint venture

When a joint venture is terminated by its investors, the net assets of the joint venture may be distributed to the investors or sold to a third party. Example 5-9 illustrates the accounting by an investor for the receipt of the net assets of the joint venture upon its termination.

**EXAMPLE 5-9**

Accounting for an investor’s receipt of a distribution of net assets constituting a business from its joint venture

During 20X2, Company A and Company B established a joint venture, Newco, through the contribution of nonmonetary assets. Book values of the nonmonetary assets were equal to fair values at the time of the contribution. Since Company A and Company B have joint control over Newco and Newco meets the definition of an accounting joint venture, each investor accounts for its investment under the equity method of accounting.

During 20X4, the investors decide to end their joint venture in Newco and proceed with a plan to distribute the net assets of the venture to the investors in proportion to their 50:50 ownership interest. Newco distributes its assets such that each investor receives 50% of the total asset value. Each group of net assets received by the two investors constitutes a business as defined by ASC 805-10-20.
What is the accounting for the liquidating distribution of the net assets of Newco to the investors of Newco upon its termination?

**Analysis**

Each investor effectively owned a 50% noncontrolling equity interest in each business prior to the dissolution. In the dissolution, each investor would exchange its 50% equity investment in one of the businesses for a controlling financial interest in the other business. Therefore, given that each investor would obtain control of a business, the investor's accounting is within the scope of ASC 805 and ASC 810-10, and should be accounted for using the guidance for a business combination achieved in stages. In this scenario, a gain (or loss) would be recognized on both the interest sold (which represents a business) and the remeasurement of the previously held equity interest effectively retained (which also represents a business).

For example, the transaction would be accounted for by Company A as follows:

At the time of the transaction, assume Newco’s net assets have a fair value of $400 million and a book value of $300 million attributable proportionately between the businesses. As a result, Company A effectively sells its 50% in a business (with a fair value of $200 million and book value of $150 million), and acquires control of a business by purchasing the 50% interest in the other business (also with a fair value of $200 million and book value of $150 million) for which Company A had a previously held equity interest. Company A would record its basis in the acquired business based on the consideration transferred of $200 million (fair value of business sold) and record the assets acquired and liabilities assumed, including the remeasurement of its previously held equity interest. Company A would recognize a total gain of $50 million on the transaction as follows.

```
Dr. Net assets of business acquired $200 million
Cr. Investment in Newco $150 million
Cr. Gain on previously held equity interest $ 25 million
Cr. Gain on sale of business to Company B $ 25 million
```

If the equity investment in Newco was exchanged for net assets that did not constitute a business, the transaction would not fall within the scope of ASC 805.
Chapter 6:
Intercompany transactions and other matters
6.1 Chapter overview

This chapter discusses considerations related to intercompany transactions between a parent and its subsidiaries. This chapter also discusses other unique accounting matters such as collaborative arrangements, proportionate consolidation, and not-for-profit organization consolidation considerations.

Refer to FSP 18.6.2 for guidance on consolidation procedures when a reporting entity is required to consolidate a subsidiary with a different period end (i.e., lag reporting). Refer to CG 4.5.7 for additional guidance on lag reporting.

6.2 Intercompany transactions

The term “intercompany (intra-entity) income” as used in this chapter refers to profit arising from transfer of inventories, properties, or other assets between companies included in consolidated financial statements (including VIEs). Intercompany profit may also arise from the sale of services or other charges (e.g., interest) that are capitalized by the purchasing affiliated company.

The general objective of intercompany income elimination in consolidated statements is to exclude from consolidated shareholders’ equity the profit or loss arising from transactions within the consolidated entity and to adjust correspondingly the carrying amount of assets remaining in the consolidated entity. Generally, the gross profit of the selling company is used to adjust the carrying amounts; however, where the selling company would ordinarily capitalize inventoriable costs, it is appropriate for such costs to be capitalized in consolidation by adjustment of the amount of profit eliminated.

ASC 323-10 discusses the equity method of accounting as it applies to corporate joint ventures and investees and states that “intra-entity (intercompany) income shall be eliminated until realized by the investor or investee as if the investee company were consolidated.” However, ASC 323-10-35-9 permits partial elimination of intercompany income on transactions with companies accounted for by the equity method. Refer to CG 4.5.2 for a discussion of intercompany income elimination under the equity method.

Any profit or loss on a leasing transaction with a related party investee (consolidated or at equity) should be accounted for in accordance with the principles set forth in ASC 810-10 or ASC 323-10 as appropriate.

Intercompany income should be eliminated from the applicable asset reflected in the consolidated balance sheet on a before-tax basis. Refer to TX 2.4.5 for a discussion of the tax effects of intercompany transactions.

6.2.1 Accounting for intercompany transactions with VIEs

An entity should consolidate a VIE for which it is the primary beneficiary pursuant to ASC 810-10-25-38 through ASC 810-10-25-38G. After a primary beneficiary initially consolidates a VIE, the basic principles of consolidated financial statements for voting interest entities in ASC 810-10 apply to the primary beneficiary’s accounting for the consolidated VIE, with one exception. For a VIE, intercompany income eliminations may not be attributed pro rata between the primary beneficiary and the noncontrolling interests.
ASC 810-10-35-3 explicitly states that (1) any intercompany fees, as well as other sources of income or expenses between a primary beneficiary and a consolidated VIE, should be eliminated against the related expense or income of the variable interest entity and (2) the resulting effect of that elimination on net income or expense of the variable interest entity should be attributed to the primary beneficiary and not to any noncontrolling interest (NCI) in the consolidated financial statements. Therefore, when consolidating a VIE, the elimination of the full intercompany profit should be attributed to the primary beneficiary.

**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.

Accordingly, except as noted above, the consolidation principles described herein should be followed when accounting for consolidated variable interest entities. Within this chapter, the term “parent” includes the “primary beneficiary” as defined in the Master Glossary of the ASC, and the terms “consolidated subsidiary” or “majority-owned subsidiary” include a “consolidated variable interest entity” as defined in the Master Glossary of the ASC for which the primary beneficiary may own some or no equity interest.

### 6.2.2 Basic principles of intercompany transactions

ASC 810 establishes basic consolidation principles, which include (1) any intercompany income on assets remaining within the consolidated group of companies should be eliminated and (2) the amount of intercompany income to be eliminated is not affected by the existence of an NCI.

**ASC 810-10-45-1**

In the preparation of consolidated financial statements, intra-entity balances and transactions shall be eliminated. This includes intra-entity open account balances, security holdings, sales and purchases, interest, dividends, and so forth. As consolidated financial statements are based on the assumption that they represent the financial position and operating results of a single economic entity, such statements shall not include gain or loss on transactions among the entities in the consolidated group. Accordingly, any intra-entity profit or loss on assets remaining within the consolidated group shall be eliminated; the concept usually applied for this purpose is gross profit or loss (see also paragraph 810-10-45-8).
ASC 810-10-45-18

The amount of intra-entity income or loss to be eliminated in accordance with paragraph 810-10-45-1 is not affected by the existence of a noncontrolling interest. The complete elimination of the intra-entity income or loss is consistent with the underlying assumption that consolidated financial statements represent the financial position and operating results of a single economic entity. The elimination of the intra-entity income or loss may be allocated between the parent and noncontrolling interests.

In consolidation, the following are observed practices related to recurring transactions (e.g., inventory) with partially-owned subsidiaries:

- When a sale is made by the parent to a partially-owned subsidiary, the entire elimination of the intercompany gain or loss is generally attributed to the controlling interest. Refer to CG 6.2.2 for additional details.

- When the profit arises from the sale by a subsidiary with an NCI to the parent, the entire intercompany profit elimination is either (1) attributed entirely to the controlling interest or (2) attributed proportionately between the controlling and NCI (this method is not allowed for VIEs, as described in CG 6.2.1.1). Refer to CG 6.2.3 for additional details.

In either case, the amount of profit eliminated from the asset is not affected by the existence of an NCI in the subsidiary. The complete elimination of the intercompany income is consistent with the underlying assumption that consolidated statements represent the financial position and operating results of a single economic entity.

As further discussed in BCG 7.2, sales or transfers of fixed assets and other long-term assets between entities under common control are generally recorded at their carrying amounts at the day of transfer.

6.2.3 Parent sells to partially-owned subsidiary

For transactions in which a parent company or primary beneficiary sells to a partially-owned subsidiary or a consolidated VIE, the elimination of the entire intercompany profit is usually attributed to the controlling interest. In consolidated financial statements, the full attribution of eliminated profits to the controlling interest is appropriate because the intercompany transactions in such cases are not viewed as arm’s-length even if expressed in terms of objective market prices. The same guidance should be applied in the parent’s consolidated financial statements in situations in which a wholly-owned subsidiary (investee) sells to a partially-owned subsidiary.

The attribution of the full elimination to the controlling interest is demonstrated in Example 6-1.

EXAMPLE 6-1

Parent sells to partially-owned subsidiary – full intercompany income elimination is attributable to parent

At the beginning of the year, Company A purchases a 60% interest in Company B for $120. At that time, the fair value of Company B’s net assets is $200, and the fair value of the NCI is $80. Company B’s total capital is $200.
During the year, Company A sells goods to Company B that are in Company B’s inventory at year end. The transaction resulted in a profit to Company A as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling price</td>
<td>$100</td>
</tr>
<tr>
<td>Less: cost of sales</td>
<td>(60)</td>
</tr>
<tr>
<td>Profit</td>
<td>$40</td>
</tr>
</tbody>
</table>

Sales and expense information for Company A and Company B on a separate company basis, before giving effect to intercompany eliminations and NCI income (expense), is as follows:

<table>
<thead>
<tr>
<th></th>
<th>Company A</th>
<th>Company B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$1,000</td>
<td>$400</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(600)</td>
<td>(260)</td>
</tr>
<tr>
<td>Profit</td>
<td>$400</td>
<td>$140</td>
</tr>
<tr>
<td>Selling and administrative</td>
<td>160</td>
<td>40</td>
</tr>
<tr>
<td>Net income</td>
<td>$240</td>
<td>$100</td>
</tr>
</tbody>
</table>

How should Company A account for the intercompany eliminations assuming no allocation is made to the noncontrolling interest?

*Analysis*

The following journal entries demonstrate the intercompany eliminations when the entire intercompany income eliminated in consolidation is attributed to the controlling interest.

**To eliminate Company A’s investment in Company B:**

- Capital stock in Company B $120
- Investment in Company B $120

**To eliminate intercompany sales and intercompany income in inventory that has not been sold by Company B at year end:**

- Sales $100
- Cost of sales $60
- Inventory $40

**To record NCI in Company B:**

- Capital stock in Company B ($200 total capital x 40%) $80
- Noncontrolling interest in Company B $80
Summary of elimination attributed to controlling interest

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consolidated net income prior to elimination of intercompany profit</td>
<td>$340</td>
</tr>
<tr>
<td>Elimination of intercompany profit in inventory</td>
<td>(40)</td>
</tr>
<tr>
<td>Consolidated net income</td>
<td>$300</td>
</tr>
<tr>
<td>Net income attributable to NCI</td>
<td>40</td>
</tr>
<tr>
<td>Net income attributable to Company A</td>
<td>$260</td>
</tr>
</tbody>
</table>

The NCI in income of Company B would be calculated as Company B’s net income of $100 x 40% NCI in Company B. The result is that the full amount of the intercompany profit elimination would be attributed to the controlling interest.

In Year 2, assume Company B sells all of the inventory. Cost of sales would have to be reduced by the prior period’s intercompany profit elimination, the effect of which would be attributed entirely to the controlling interest.

For example, in Year 2, assume Company B sells all of the inventory it purchased from Company A during Year 1 for $120. The earnings of Company B would still be allocated 60/40 to Company A and the NCI, but because Company A would need to also add back the prior period intercompany profit elimination, the amount attributed to the controlling interest would be $52, calculated as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company B selling price</td>
<td>$120</td>
</tr>
<tr>
<td>Company B cost of sales</td>
<td>(100)</td>
</tr>
<tr>
<td>Company B profit</td>
<td>$20</td>
</tr>
<tr>
<td>Company A’s 60% share of Company B profit</td>
<td>$12</td>
</tr>
<tr>
<td>Plus: reduction in cost of sales</td>
<td>40</td>
</tr>
<tr>
<td>Total income attributable to Company A</td>
<td>$52</td>
</tr>
</tbody>
</table>

**6.2.4 Partially-owned subsidiary sells to parent**

When a partially-owned subsidiary sells to a parent company, there are two acceptable approaches under ASC 810-10-45-18 to attributing the elimination of the intercompany profit or loss. The elimination of intercompany profit or loss may either be fully attributed to the controlling interest, or attributed proportionately between the controlling and noncontrolling interests.

Under the full attribution approach, net income attributable to the parent is charged for the entire intercompany income, including the noncontrolling interest’s share. This approach is less complex in application and is based on a view that the parent controls the sale and should eliminate the entire sale in its accounting. However, some believe that the full attribution of the elimination of the
intercompany profit made on a sale by a partially-owned subsidiary to its parent understates net income attributable to the parent by the share of intercompany income earned from sale to the NCI.

The attribution of the intercompany income elimination proportionately between the parent and noncontrolling interests reflects the net income earned by the parent for its share of intercompany net income earned to the extent of outside interests. However, it has the disadvantage in consolidated financial statements of understating the equity of the NCI in net assets of the subsidiary by the amount of profit remaining in the parent’s assets (i.e., inventory) attributable to the noncontrolling interest of the selling subsidiary. Further, this approach cannot be applied when consolidating a VIE as it is restricted by ASC 810-10-35-3. See CG 6.2.1.1 for further information.

In situations in which a partially-owned subsidiary sells to a wholly-owned subsidiary, the wholly-owned buying subsidiary should be regarded as the parent entity and the same guidance as discussed above should be applied in the parent’s consolidated financial statements. In situations in which a partially-owned subsidiary sells to a partially-owned subsidiary, the entire amount of intercompany profit must be eliminated in arriving at consolidated net income. The amount of the intercompany profit elimination attributed to the NCI should be determined consistently with the approach adopted by the entity for sales to the parent.

A “cost company” is a joint venture formed to serve as a source of supply in which the venturers agree to take production of the investee proportionate to their respective interests. This is substantially a cost-sharing arrangement, and the existence of an outside interest does not increase cost of supplies to the consolidated entity. For this reason, the intercompany income elimination is required to be attributed entirely to the parent.

Example 6-2 demonstrates the two different approaches of attributing the elimination of intercompany profit or loss.

**EXAMPLE 6-2**

**Partially-owned subsidiary sells to parent – two approaches**

At the beginning of the year, Company A purchases a 60% interest in Company B for $120. At that time, the fair value of Company B’s net assets is $200, and the fair value of the NCI is $80. Company B’s total capital is $200.

During the year, Company B sells goods to Company A that are in Company A’s inventory at year end. The transaction resulted in a profit to Company B as follows:

<table>
<thead>
<tr>
<th>Selling price</th>
<th>$100</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: cost of sales</td>
<td>(60)</td>
</tr>
<tr>
<td><strong>Profit</strong></td>
<td><strong>$40</strong></td>
</tr>
</tbody>
</table>
Sales and expense information for Company A and Company B on a separate company basis, before giving effect to intercompany eliminations and NCI income (expense), is as follows:

<table>
<thead>
<tr>
<th></th>
<th>Company A</th>
<th>Company B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$1,000</td>
<td>$400</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(600)</td>
<td>(260)</td>
</tr>
<tr>
<td>Profit</td>
<td>$400</td>
<td>$140</td>
</tr>
<tr>
<td>Selling and administrative</td>
<td>160</td>
<td>40</td>
</tr>
<tr>
<td>Net income</td>
<td>$240</td>
<td>$100</td>
</tr>
</tbody>
</table>

How should Company A eliminate the intercompany profit using full attribution to the controlling interest?

**Analysis – full attribution approach**

The following journal entries demonstrate the intercompany eliminations when the entire intercompany income eliminated in consolidation is attributed to the controlling interest.

**To eliminate Company A’s investment in Company B:**
- Capital stock in Company B $120
- Investment in Company B $120

**To eliminate intercompany sales and intercompany income in inventory that has not been sold by Company A at year end:**
- Sales $100
- Cost of sales $60
- Inventory $40

**To record NCI in Company B:**
- Capital stock in Company B $80
- Noncontrolling interest in Company B $80

Under the full attribution approach, the noncontrolling interest would recognize profit on the sale of inventory to the parent. The attribution of income of Company B to the NCI would be calculated as Company B’s net income of $100 x 40% NCI in Company B.

Company A would not recognize profit on the intercompany sale of inventory. Company A would recognize its standalone profit of $240, plus its 60% share of the subsidiary’s $100 income ($60), less the entire income on the intercompany transaction of $40.
The attribution of Company B’s net income in consolidation and the entire intercompany elimination to Company A is shown below.

<table>
<thead>
<tr>
<th>Share of Company B’s net income</th>
<th>Company A</th>
<th>NCI</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>$60</td>
<td>$40</td>
<td></td>
<td>$100</td>
</tr>
</tbody>
</table>

| Full attribution of intercompany elimination to controlling interest | (40) | —   | (40) |

| Total | $20 | $40 | $60 |

In Year 2, assume Company A sells all of the inventory. Cost of sales would have to be reduced by the prior period’s intercompany profit elimination, the effect of which would be attributed entirely to the controlling interest. The entire $40 profit would be attributed to Company A in Year 2, such that by the end of Year 2, Company A would have recognized its full 60% share of Company B’s profit.

How should Company A eliminate the intercompany profit if it is attributed proportionately between the controlling and noncontrolling interest?

**Analysis – proportionate attribution approach**

The following journal entries demonstrate the intercompany eliminations when the entire intercompany profit eliminated in consolidation is attributed proportionately between the controlling and noncontrolling interests. This method is not permissible for consolidated VIEs.

**To eliminate Company A’s investment in Company B:**

- Capital stock in Company B $120
- Investment in Company B $120

**To eliminate intercompany sales and intercompany income in inventory which has not been sold by Company A at year end:**

- Sales $100
- Cost of sales $60
- Inventory $40

**To record NCI in Company B:**

- Capital stock in Company B $80
- Noncontrolling interest in Company B $80

Under the proportionate attribution approach, the noncontrolling interest would recognize income of $24, which represents its 40% share of Company B’s $100 net income ($40), less its 40% share of the remaining profit in inventory of $40 ($16).

In addition to its standalone profit of $240, Company A would recognize its 60% share of Company B’s $100 net income ($60), less its 60% share of the remaining profit in inventory of $40 ($24).
The proportionate attribution of Company B’s net income and the intercompany elimination in consolidation to Company A and the NCI is shown below.

<table>
<thead>
<tr>
<th></th>
<th>Company A</th>
<th>NCI</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share of Company B’s net income</td>
<td>$ 60</td>
<td>$ 40</td>
<td>$ 100</td>
</tr>
<tr>
<td>Proportionate attribution of intercompany elimination</td>
<td>(24)</td>
<td>(16)</td>
<td>(40)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$ 36</td>
<td>$ 24</td>
<td>$ 60</td>
</tr>
</tbody>
</table>

In Year 2, when Company A sells all of the inventory, cost of sales would have to be reduced by the prior period’s intercompany profit elimination, and a similar adjustment made to the attribution of income to Company B. In Year 2, 60% of Company B’s $40 profit ($24) would be attributed to Company A, such that by the end of Year 2 Company A would have recognized its full 60% share of Company B’s profit.

The summary below compares the consolidated net income and adjustments under the two approaches.

<table>
<thead>
<tr>
<th></th>
<th>Full attribution to controlling interest</th>
<th>Partial attribution to NCI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consolidated net income prior to elimination of intercompany profit</td>
<td>$ 340</td>
<td>$ 340</td>
</tr>
<tr>
<td>Elimination of intercompany profit</td>
<td>(40)</td>
<td>(40)</td>
</tr>
<tr>
<td>Consolidated net income</td>
<td>$ 300</td>
<td>$ 300</td>
</tr>
<tr>
<td>Net income attributable to NCI</td>
<td>40</td>
<td>24</td>
</tr>
<tr>
<td>Net income attributable to Company A</td>
<td>$ 260</td>
<td>$ 276</td>
</tr>
</tbody>
</table>

**6.2.5 Intercompany inventory transactions and the lower of cost or net realizable value test**

When intercompany transactions result in a profit, the new basis (cost) of the inventory on the books of the company holding the inventory will include the entire intercompany profit. The intercompany profit and related income taxes are normally eliminated in consolidation.

As part of its normal inventory accounting, as prescribed by ASC 330, *Inventory*, inventory is recorded at the lower of cost or net realizable value (NRV). NRV is defined as the estimated selling price less the cost of completion and sale. If cost exceeds net realizable value, an inventory write-down should be recorded. To the extent that the write-down gives rise to an immediate or a future (upon realization of the inventory loss) tax deduction that, under ASC 740, *Income Taxes*, meets the “more likely than not” criterion, a tax benefit would be recorded as part of the normal calculation of income tax expense. The adjusted amounts should be used for consolidation purposes, which means that the parent and NCI in...
the company holding the inventory will reflect their respective shares of the recorded inventory write-down net of any tax benefit recorded.

In consolidation, the intercompany income (and related tax effect) that is to be eliminated should be reduced to consider the inventory write-down recorded by the company holding the inventory.

The procedures discussed above are summarized in the following steps:

□ The company holding the inventory should apply the lower of cost or net realizable value test based on its carrying cost.

□ If a write-down is required, it should be recorded in the books of the company holding the inventory. The write-down will be reflected in that company’s calculation of its income tax provision and thus the tax benefit related to the write-down (to the extent recognizable under ASC 740) will be reflected in the standalone entity financial statements.

□ The financial statements of the company holding the inventory, as adjusted, should be used in consolidation. As a result, the consolidated financial statements will reflect both the parent’s and the NCI’s respective shares of that net loss.

□ From a consolidated point of view, it is generally necessary to adjust the parent’s share of intercompany income that would ordinarily be eliminated in consolidation in order to partially or fully offset the parent’s share of the write-down recorded by the company holding the inventory. However, if the parent’s share of the write-down is greater than the parent’s share of the intercompany income elimination, then the adjustment for the parent’s share of the intercompany income elimination is not necessary. On the other hand, if the parent’s share of the write-down is less than its share of the intercompany income elimination, then the amount of the normal intercompany elimination should be reduced by the parent’s share of the write-down.

□ Whenever the amount of profit eliminated in consolidation is adjusted to take into account an inventory write-down, a corresponding adjustment may need to be made to the income taxes previously paid on the intercompany income (i.e., deferred charge) in consolidation. This is because the amount that continues to be deferred is subject to an after-tax realization test, as discussed in TX 2.4.5.2.

Example 6-3 illustrates the accounting for a write-down of inventory purchased by a partially-owned subsidiary from its parent that was sold at a profit.

**EXAMPLE 6-3**

Parent sells inventory to partially-owned subsidiary – lower of cost or NRV test

At the beginning of the year, Company A purchases a 60% interest in Company B for $120. At that time, the fair value of Company B’s net assets is $200, and the fair value of the NCI is $80. Company B’s total capital is $200.

Intercompany profits are eliminated in their entirety and fully attributed to the parent (Company A) as described in Example 6-1.
During the year, Company A sells goods to Company B that are in Company B’s inventory at year end. There were no other intercompany transactions during the year. The intercompany sale of inventory resulted in a profit to Company A and a related tax expense on a standalone basis as follows:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling price</td>
<td>$ 100</td>
</tr>
<tr>
<td>Less: cost of sales</td>
<td>(60)</td>
</tr>
<tr>
<td>Profit before tax</td>
<td>$ 40</td>
</tr>
</tbody>
</table>

At the end of the year, the goods acquired from Company A by Company B have an NRV of $70. As shown below, Company B writes down the inventory to net realizable value, with the $30 adjustment to cost of sales reflected in Company B’s income statement. In computing its current provision for income taxes, the $30 write-down is fully deductible.

<table>
<thead>
<tr>
<th></th>
<th>Company B</th>
<th>NRV write-down</th>
<th>Company B after write-down</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>$ 100</td>
<td>$(30)</td>
<td>$ 70</td>
</tr>
<tr>
<td>Sales</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>COGS</td>
<td>—</td>
<td>(30)</td>
<td>(30)</td>
</tr>
<tr>
<td>Pretax (loss)</td>
<td>—</td>
<td>$(30)</td>
<td>$(30)</td>
</tr>
</tbody>
</table>

**Analysis**

The following journal entries demonstrate the intercompany eliminations that should be recorded in consolidation, as well as the impact to Company A’s accounts of the inventory write-down that was recorded by Company B. For ease of illustration, tax effects have been ignored.

To eliminate intercompany sales and intercompany income in inventory before giving effect to the inventory write-down recorded by Company B:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$ 100</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>$ 60</td>
</tr>
<tr>
<td>Inventory</td>
<td>$ 40</td>
</tr>
</tbody>
</table>

Consistent with Example 6-1 and Example 6-2, this adjustment is necessary as the sellers pretax profit is deferred in consolidation, and the asset is carried at its cost to the seller until it is sold to an unrelated third party.

To reverse the write-down of inventory recorded by Company B by recognizing intercompany profit to the extent of the write-down of $30:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>$ 30</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>$ 30</td>
</tr>
</tbody>
</table>
This adjustment is necessary as the inventory balance in consolidation has already been adjusted to reflect the seller’s cost basis of $60, which is below the $70 NRV for the inventory.

To defer profit equal to the NCI’s share of the write-down (40% of $30), which would otherwise be recognized in Company A’s income:

<table>
<thead>
<tr>
<th></th>
<th>Co A</th>
<th>Co B</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cost of sales</strong></td>
<td>$12</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Deferred income liability</strong></td>
<td>$12</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

This adjustment in effect recognizes the NCI’s share of Company B’s write-down in Company A’s consolidated financial statements, and defers Company A’s 60% share of the write-down ($18), which would be recognized when Company B sells the inventory to a third party. Because Company B wrote down the inventory by $30, and Company A’s share of that write-down is $18, Company A would recognize $22 ($40 - $18) of profit if Company B were to sell its inventory to a third party.

A summary of the adjustments and resulting balances are shown below.

<table>
<thead>
<tr>
<th></th>
<th>Co A</th>
<th>Co B</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Inventory</strong></td>
<td>—</td>
<td>$70</td>
<td>$70</td>
<td>$(40)</td>
<td>$30</td>
<td>$60</td>
<td>—</td>
<td>$60</td>
</tr>
<tr>
<td><strong>Deferred income liability</strong></td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>12</td>
<td>12</td>
</tr>
<tr>
<td><strong>Sales</strong></td>
<td>$100</td>
<td>—</td>
<td>$100</td>
<td>$(100)</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td><strong>COGS</strong></td>
<td>(60)</td>
<td>(30)</td>
<td>(90)</td>
<td>60</td>
<td>30</td>
<td>—</td>
<td>(12)</td>
<td>(12)</td>
</tr>
<tr>
<td><strong>Pretax profit</strong></td>
<td>$40</td>
<td>$(30)</td>
<td>$10</td>
<td>$(40)</td>
<td>$30</td>
<td>—</td>
<td>(12)</td>
<td>$(12)*</td>
</tr>
</tbody>
</table>

* The pretax loss of $12 represents the amount attributable to NCI that must be charged to adjust the parent’s share of the write-down. In Year 2, assume Company B sells all of the inventory at $70, cost of sales would have to be reduced by the prior period’s intercompany loss elimination, the effect of which would be attributed entirely to the controlling interest which would result in recognition of intercompany profit of $22.

### 6.2.5.1 Intercompany transactions at a loss

Both ASC 810-10-45-1 and ASC 323-10-35-7 provide for elimination of intercompany losses (by increasing the carrying amount of the related assets) in a manner consistent with intercompany income. When accounting for intercompany inventory sales at a loss, a similar procedure as described in CG 6.2.4 should be followed, but special care must be exercised in making a lower of cost or net realizable value test of the inventories of the purchasing company. NRV must cover both the carrying amount reflected in the inventories as recorded in the books of the company holding the inventories, the related tax effects on the intercompany transactions (see TX 2.4.5), and the losses deferred (added to carrying amount) by consolidating entries. If NRV is exceeded after deferring the losses in the consolidating entries, the losses that would otherwise be deferred in consolidation should be reduced,
and a corresponding adjustment made to the related tax effect, to reflect the NRV test determined at the consolidated level.

Intercompany losses should not be eliminated (deferred) if they represent a permanent loss of value of assets that should have been adjusted through lower of cost or net realizable value or other impairment models even if the assets had not been transferred to an affiliated company.

### 6.2.6 Intercompany income on sales to regulated affiliates

ASC 980-810-10-45-1 through ASC 980-810-10-45-2 provides that intercompany income arising from a sale by a nonregulated parent or affiliate to a regulated affiliate should not be eliminated if the sales price is reasonable and it is probable that, through the rate-making process, future revenue will approximate the sales price that will result from the regulated affiliate's use of the products. The sales price usually would be considered reasonable if it is accepted or not challenged by the regulator that governs the regulated affiliate. See UP 17 for guidance on intercompany transactions with a regulated entity.

### 6.3 Joint venture vs collaborative arrangements

When an investor is evaluating whether it has entered into a joint venture arrangement, the investor should consider whether the arrangement is instead a collaborative arrangement. A collaboration arrangement is a series of contracts that cause entities to share economic risks and rewards, as defined in ASC 808.

**Definition from ASC 808-10-20**

Collaborative arrangement: A contractual arrangement that involves a joint operating activity. These arrangements involve two (or more) parties that meet both of the following requirements: (a) they are active participants in the activity and (b) they are exposed to significant risks and rewards dependent on the commercial success of the activity.

Entities may enter into arrangements to participate in a joint operating activity to develop and commercialize intellectual property (i.e., the development and commercialization of a new drug, software, computer hardware, or a motion picture). Collaborative arrangements in the scope of ASC 808 are usually executed through contracts, and are typically not conducted through a separate legal entity created by the sponsors specifically to perform the joint operating activity.

When a collaborative arrangement is conducted through a separate legal entity, the sponsors should evaluate whether joint venture accounting applies, as discussed in CG 5. If the arrangement does not meet the criteria to apply joint venture accounting, the sponsors would likely apply the equity method, as discussed in CG 4.

Sponsors are specifically prohibited from applying the equity method of accounting to collaborative arrangements in which a separate legal entity does not exist as per ASC 808-10-15-4. For arrangements where a separate legal entity does not exist, costs incurred and revenue generated from transactions with third parties should be reported by the participant in the collaborative arrangement.

In November 2018, the FASB issued ASU 2018-18, Clarifying the Interaction between Topic 808 and Topic 606, which clarifies when transactions between parties to collaborative arrangements are in the
Intercompany transactions and other matters

The ASU clarifies that a collaborative arrangement could be partially in the scope of other guidance, including ASC 606. The amendments also specify that companies should apply the “distinct” guidance in ASC 606 for the purpose of determining whether ASC 606 is applicable to part of an arrangement. If a transaction is outside the scope of ASC 606, the related amounts cannot be presented together with revenue in the scope of ASC 606.

To determine whether a portion of a collaborative arrangement is in the scope of ASC 606, the guidance in ASC 606 on identifying “distinct” goods and services should be applied to identify each unit of account within the arrangement. That guidance requires first assessing whether a good or service is capable of being distinct, based on whether the counterparty can benefit from the good or service either on its own or with resources that are readily available. Second, the guidance requires companies to assess whether a good or service is separately identifiable from other promises in the contract. In other words, companies must assess whether the nature of the promise, within the context of the collaborative arrangement, is to transfer each of the goods or services individually or, instead, to transfer a combined item to which the promised goods or services are inputs.

Collaborative arrangements often include a license to intellectual property in addition to various activities, such as research and development, manufacturing, and other commercialization activities. Assessing whether these activities are distinct could require significant judgment, particularly when all of the activities within the collaborative arrangement have some level of interdependence. Goods or services that are not distinct are combined with other goods or services in the contract until a bundle of goods or services that is distinct is identified.

Once the units of account within a collaborative arrangement are determined, an entity should assess if all or part of each unit of account is a transaction with a customer. A customer is a party that has contracted to obtain goods or services that are an output of the entity’s ordinary activities in exchange for consideration. If an entire unit of account is a transaction with a customer, ASC 606 should be applied to that unit of account, including all recognition, measurement, presentation, and disclosure requirements.

If the entire unit of account is not a transaction with a customer, that unit of account is not in the scope of ASC 606. This would be the case, for example, if some aspect of the single unit of account is determined to be with a collaborative partner not in the capacity of a customer. In these circumstances, the reporting entity can apply (1) elements of the accounting under ASC 606, (2) other relevant guidance by analogy, or (3) a reasonable accounting policy if there is no appropriate analogy. Companies should consider the nature of the arrangement and its business operations to determine the appropriate accounting for portions of a collaborative arrangement outside the scope of ASC 606.

Transactions with collaborative partners in the scope of ASC 606 are subject to all of the presentation and disclosure guidance in that standard. The amendment precludes entities from including transactions outside the scope of ASC 606 with revenue subject to ASC 606; however, the guidance does not prescribe any specific presentation for these transactions.

ASC 808 permits entities to present transactions based on an analogy to other authoritative guidance, or a reasonable, rational and consistently applied policy election, if there is no appropriate analogy. Judgment should be applied in determining how to account for transactions within a collaborative arrangement that are not in the scope of ASC 606. Given that the amendments do not provide specific guidance for these transactions, limited changes from current accounting policies in this area are expected. As a result, it is likely that diversity in how entities account for these transactions will continue. There may be instances when it will be acceptable to present transactions in the scope of
ASC 808 as “revenue;” however, these amounts cannot be included with revenue in the scope of ASC 606.

ASU 2018-18 is effective for public business entities for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. The guidance is effective for nonpublic business entities for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021. Companies can early adopt the new guidance, but no earlier than their adoption of ASC 606.

An entity should apply the amendments in ASU 2018-18 retrospectively, with the cumulative effect of initially applying the guidance recognized as a cumulative adjustment to retained earnings (modified retrospective) at the later of (1) the earliest annual period presented or (2) the date of initial application of ASC 606. For example, a calendar year-end public company that will adopt the ASU on January 1, 2019, and adopted ASC 606 on January 1, 2018, would record the cumulative effect of adopting this amendment as of January 1, 2018. Financial information in periods subsequent to January 1, 2018 would be recast in the period of adoption (e.g., first quarter 2018 would be recast when shown as prior period information with first quarter 2019).

Practical expedients similar to the modified retrospective transition method for ASC 606 are available. Under the expedients, an entity may elect to apply the amendments retrospectively either to all collaborative arrangements or only to uncompleted collaborative arrangements at the date of initial application of ASC 606. Also, entities may elect the practical expedient for contract modifications permitted under ASC 606, which allows an entity to aggregate the effects of all contract modifications that occur before the adoption date. Entities should disclose their use of these elections.

Example 6-4, which is based on Example 4 in ASC 808-10-55, illustrates the accounting considerations for a collaborative arrangement when a separate legal entity does not exist.

**EXAMPLE 6-4**
**Determining the relevant accounting model to apply to a collaborative arrangement**

Company A and Company B agree to jointly participate in the production and distribution of a major motion picture. Company A will manage the day-to-day production activities and will be responsible for distribution in the United States. Company B will be responsible for the distribution in Europe and Asia.

The terms of the arrangement state that both companies will share equally in all production costs incurred. Further, Company A will pay 50% of the net profits (that is, revenues less distribution costs) from the United States distribution to Company B, and Company B will pay 50% of the net profits from European and Asian distribution to Company A. The companies are responsible for initially funding all distribution costs in their respective locations. For purposes of this example, no license to intellectual property has been conveyed to Company B.

How should Company A account for the costs incurred and revenue generated from the transactions?

*Analysis*

As Company A has entered into a collaborative arrangement with Company B without the formation of a separate legal entity, Company A would be prohibited from applying the equity method of
accounting to the arrangement. During production, Company A would look to the guidance in ASC 605-45 (ASC 606 after the adoption of ASU 2018-18), and if Company A determined that it was the principal for the revenue generated from third parties in the United States, Company A would record the gross revenue from the United States distribution as revenue in its income statement, and likewise record all of the associated distribution costs for distribution in the United States.

Company A would record a receivable from Company B for half of the production costs, with a corresponding reduction of its capitalized film costs. Regarding the income statement classification of net participation costs owed to or from Company B, prior to the adoption of ASU 2018-18, Company A would look to its own accounting policy assuming no other accounting literature applies either directly or by analogy. For example, Company A’s accounting policy may be that it records net participation costs due from production partners as additional revenue and net amounts due to production partners as a cost of sales. After the adoption of ASU 2018-18, Company A should consider whether net participation remittances from Company B are within the scope of ASC 606 and, if so, account for these receipts as revenue.

6.3.1 Research and development arrangements

Companies may enter into unique arrangements, such as R&D focused partnerships, strategic alliances, and collaborations to fund research and development activities. When those arrangements do not involve a separate legal entity, but are structured through contractual arrangements whereby the entities actively participate in the research and development of a product, the arrangement may qualify for accounting as a collaborative arrangement in accordance with ASC 808. The demand for new sources of capital has led many companies to explore innovative R&D funding arrangements. Oftentimes various partners or investors, who may be financial/passive investors, assist in development funding and share the financial risks and rewards of the R&D efforts. If these investors are not actively participating in the R&D efforts, the investment would not be in scope of ASC 808 and the investors should assess whether the arrangement is within the scope of ASC 730-20, Research and Development Arrangements, or ASC 470-10-25, Sales of Future Revenues.

Arrangements between pharmaceutical companies (“Pharma”) and financial investors have become more prevalent in recent years. These arrangements tend to utilize one of the following strategies:

- Direct R&D Funding: This strategy is predicated on a financial investor providing direct funding to Pharma for specified R&D projects in return for future payments (e.g., milestone payments, royalties on sales) contingent upon successful completion of the R&D.

- Newco R&D Funding: This strategy involves a third party investor establishing a new entity to perform the R&D, which may be outsourced back to Pharma or to an unaffiliated contract research organization, often with a predetermined exit (e.g., providing Pharma a call option or contingent forward purchase) only upon successful completion of the R&D.

A company that actively participates in a direct R&D funding arrangement should look to ASC 808 to determine whether it has entered into a collaboration arrangement. The company may then need to consider accounting guidance per ASC 606, Revenue from Contracts with Customers, ASC 730, Research and Development, or ASC 470, Debt.
A company with an interest in a new entity that was created to facilitate an R&D funding arrangement should evaluate whether it is required to consolidate the entity under the guidance in ASC 810. Refer to CG 2 for further information.

6.4 Proportionate consolidation

The term “proportionate consolidation” means presenting an investor’s pro-rata share of a venture’s assets and liabilities in each applicable line item of the investor’s balance sheet, and pro-rata results of a venture’s operations in each applicable line item in its income statement. This presentation may be used in two situations, if certain conditions are met.

□ Undivided interest

In this situation, the investor does not have an ownership interest in a legal entity but rather has an undivided ownership interest in assets, and is proportionately liable for each liability. In this case, the reporting entity is outside of the scope of equity method accounting (ASC 323) and proportionate consolidation is appropriate, except as described in the following paragraph.

If the venture holds real estate assets subject to joint control, then the investment would be in the scope of ASC 323 due to the guidance in ASC 970-323-25-12 and proportionate presentation would be precluded. The presentation and disclosure requirements of ASC 323 would apply.

In the utilities industry, there are unique considerations for undivided interests predicated on an SEC Staff Accounting Bulletin that is further discussed in UP 15.

Also, as discussed in Chapter 3.02 of the AICPA Audit and Accounting Guide, Entities With Oil and Gas Producing Activities, ownership of oil and gas is usually through a mineral interest, which is an economic interest in underground minerals. Such an arrangement does not involve a separate legal entity, and each party holds an individual interest in the asset and is proportionately liable for any liabilities. As a result, these arrangements are accounted for using proportionate consolidation.

□ Equity method in the construction and extractive industries

In this situation, the investor has an ownership interest in an unincorporated legal entity. An investor that holds a noncontrolling ownership interest in an unincorporated legal entity in the construction or extractive industries that qualifies for the equity method of accounting may elect proportionate consolidation in accordance with ASC 810-10-45-14. This is the case even if another reporting entity consolidates the legal entity.

In determining whether a legal entity is an unincorporated entity, the reporting entity should consider the governance attributes and economic characteristics of the legal entity to determine whether it is more akin to a corporation or a partnership. For example, if the legal entity has governance attributes that are more representative of a corporation (e.g., a board of directors as opposed to a general partner or managing member), it generally would not be considered an unincorporated legal entity. For more information, see CG 3.5.4.

To qualify as an extractive industry, activities of the investee must be limited to extraction of mineral resources, such as oil and gas exploration and production. A reporting entity with a noncontrolling investment in an unincorporated legal entity engaged in activities such as refining,
marketing, or transporting extracted mineral resources would not qualify to elect proportionate consolidation. In that case, the presentation and disclosure requirements of ASC 323 would apply.

6.5 **Consolidation considerations for not-for-profit entities**

Not-for-profit entities (NFPs) evaluate relationships with other entities for consolidation using a voting interest model, rather than the variable interest model prescribed in ASC 810-10-15; however, the specific accounting model applied depends on whether the relationship is with an NFP or a for-profit entity. The Master Glossary of the ASC defines an NFP as follows.

**Definition from ASC Master Glossary**

Not for profit entity: An entity that possesses the following characteristics, in varying degrees, that distinguish it from a business entity:

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

Entities that clearly fall outside this definition include the following:

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

6.5.1 **Consolidation of other NFPs**

Authoritative guidance on the not-for-profit industry-specific voting interest model is provided in ASC 958-810, *Not-for-Profit Entities—Consolidation*, with additional commentary provided in the AICPA Audit and Accounting Guide—NFP, Chapter 3, and AAG—Health Care Entities (“HCO”), Chapter 12. Under the ASC 958 model, the form of control dictates the circumstances that would require consolidation. The forms of control are:

- □ Sole corporate membership
- □ Control of majority voting interest in the board
- □ Control by other means (e.g., through contract or affiliation agreement)
In summary, ASC 958-810’s consolidation requirements are:

- Reporting NFP is the sole corporate member of another NFP—consolidate unless control does not rest with the sole corporate member.

- Reporting NFP controls another NFP through having a majority voting interest in its board and has an economic interest in that entity—consolidate unless control does not rest with the holder of the majority voting interest. “Control” and “economic interest” are defined and illustrated in ASC 958-810.

- Reporting NFP controls another NFP through means other than sole corporate membership or majority voting interest (e.g., through contract or affiliation agreement) and has an economic interest in that other entity—consolidation is permitted but not required.

- Reporting NFP has control over another NFP or an economic interest in another NFP, but not both—consolidation is prohibited.

Some NFPs’ articles of incorporation utilize a “membership structure.” This refers to a legal structure in which the powers to make fundamental corporate decisions (e.g., amending the articles of incorporation or bylaws) that are normally granted to a board of directors are instead “reserved” to “corporate members” identified in the NFP’s articles of incorporation. When an NFP’s articles of incorporation provide for a single “member,” that party is referred to as the sole corporate member. A sole corporate member generally holds powers equivalent to those of a sole shareholder, such as the ability to appoint and terminate the NFP’s board or dissolve the organization. According to ASC 958-810-25-2, a sole corporate member is presumed to possess a controlling financial interest that requires consolidation unless control does not rest with it (e.g., the articles or bylaws may provide approval or veto rights to a party other than the sole corporate member that are so restrictive that they call into question whether control rests with the sole corporate member). The discussion in ASC 810-10-25-2 through 25-14 on the effect of noncontrolling rights on consolidation may be helpful in evaluating situations where a sole corporate member’s control may be in question.

Normally, a majority voting interest arises from situations where an NFP’s articles of incorporation provide another organization with the right to appoint a majority of its governing board. The “right to appoint” is the key determinant of whether a majority voting interest exists. For example, according to ASC 958-810-55-5, if a majority of an NFP’s board is comprised of individuals who are associated with a specific entity (e.g., board members, employees, or officers), the entity would not be considered to possess a majority voting interest if it lacked the ability or right to require that those individuals serve on the NFP’s board.

ASC 958-810-25-3 states that the evaluation of whether a “majority voting interest” exists is made in relation to the NFP’s fully constituted board (including any vacant board positions). For example, if vacancies on the board of an NFP cause an entity to temporarily possess a majority voting interest, that circumstance in and of itself would not require the entity to consolidate the NFP.
Economic interest is defined and described as follows.

**Definition from ASC 958-810-20**

Economic interest: A NFP’s interest in another entity that exists if any of the following criteria are met:

a. The other entity holds or utilizes significant resources that must be used for the purposes of the [reporting] NFP, either directly or indirectly by producing income or providing services.

b. The [reporting] NFP is responsible for the liabilities of the other entity.

**ASC 958-810-55-6**

The following are examples of economic interests:

a. Other entities solicit funds in the name of and with the expressed or implied approval of the NFP, and substantially all of the funds solicited are intended by the contributor or are otherwise required to be transferred to the NFP or used at its discretion or direction.

b. An NFP transfers significant resources to another entity whose resources are held for the benefit of the NFP.

c. An NFP assigns certain significant functions to another entity.

d. An NFP provides or is committed to provide funds for another entity or guarantees significant debt of another entity.

e. An NFP has a right to or a responsibility for the operating results of another entity. Or upon dissolution, an NFP is entitled to the net assets, or is responsible for any deficit, of another entity.

The examples highlight situations when a separate organization is raising funds, investing, or carrying out other significant functions for the reporting entity (so the other organization’s activities are an extension of the reporting NFP’s activities). They also consider situations when the reporting entity has financial risks or rewards associated with the separate organization, such as guarantees of debt, requirements to provide funding, or rights to operating results or net assets upon dissolution.

**6.5.1.1 Restrictions on net assets in consolidation**

When the net assets of two or more NFPs are aggregated in a consolidated presentation, special consideration should be given to the consolidating entities’ net assets without donor restrictions when viewed from a consolidated perspective. At the individual entity level, unrestricted gifts received can be used for any purposes consistent with the nature of that organization and the purposes specified in its articles of incorporation or bylaws. When the entity’s net assets without donor restrictions are incorporated into financial statements of a consolidated entity that has a broader purpose, the portion associated with donors’ unspent gifts may need to instead be reported as net assets with donor restrictions, in order to appropriately reflect the limitations on their use. Similar considerations apply when aggregating net assets of sister corporations in combined financial statements. These matters are discussed in AAG-NFP 3.107–3.109. The classification of net assets without donor restrictions
attributable to an NFP’s exchange (barter) transactions, such as fees or ticket sales, do not arise from contributions and would not need to be adjusted.

Question 6-1 addresses the classification of gifts to a subsidiary in a parent’s consolidated financial statements.

**Question 6-1**

A membership association (Parent) has an educational subsidiary whose mission is to provide scholarships. Donors make unrestricted contributions to the educational subsidiary with the intent that the subsidiary use the contributions to support its mission. Would the gifts be classified as net assets without donor restrictions in the Parent’s consolidated financial statements?

**PwC response**

No, the classification of the subsidiary’s net assets should be adjusted to reflect that they are donor-restricted net assets from the perspective of the Parent’s consolidated financial statements. The net assets without donor restrictions of the educational subsidiary resulting from contributions (or investment income on donor-restricted endowment funds) should, therefore, be reported as net assets with donor restrictions in the Parent’s consolidated financial statements (to reflect that they are not available for general use by the consolidated organization). Net assets without donor restrictions of the educational subsidiary arising from exchange transactions would not need to be adjusted, as they did not arise from contributions.

**6.5.1.2 NFP joint ventures**

NFPs may pursue a variety of approaches to combining or coordinating their services, operations, and resources. In some cases, two entities come together in their entirety (either by ceding control to a new entity, or by one entity ceding control to the other). In these situations, a not-for-profit combination has occurred. Accounting guidance for NFP combinations is discussed in ASC 958-805.

Sometimes two or more NFPs will sponsor formation of a new legal entity through which they will collaboratively provide a new service or program or carry out an essential function. Often, such arrangements are informally referred to as “not-for-profit joint ventures.” In evaluating the accounting and financial reporting for participation in such ventures, substance must be considered over form. Specifically, the characteristics of the venture should be evaluated against the U.S. GAAP definition of an NFP discussed in CG 6.5. According to that guidance, one of the defining characteristics of a NFP typically is the absence of ownership interests like those of business entities. If the NFP joint venture is housed in a stock corporation, partnership, LP, or LLC that provides the participants with ownership interests in the traditional sense, then the accounting guidance for investments in business entities would be applied, despite the fact that the purpose of the venture may be to carry out a nonprofit activity. If the venture is not conducted in a separate legal entity, it would be accounted for based on the guidance for collaborative arrangements as discussed in CG 6.3.

NFPs might also come together to form an entity that exists solely to benefit its NFP participants or members (e.g., a cooperative shared service arrangement). Often such ventures are characterized as “not-for-profit,” and in some cases they are incorporated under state not-for-profit corporation laws. Even so, if the venture was formed to provide dividends, lower costs, or other economic benefits directly and proportionately to its members or participants, then it would not meet the ASC Master Glossary definition of a NFP and, thus, NFP accounting would not be applicable. In such cases, it may
be appropriate to apply the accounting guidance for cooperatives in other industries (e.g., agriculture or real estate) by analogy.

6.5.2 **Consolidation of for-profit entities, including special-purpose entities**

ASC 958-810-15-4 and ASC 954-810-15-3 direct NFPs to relevant guidance in various locations relating to reporting investments in for-profit entities. Chapter 3 of AAG-NFP and chapter 12 of AAG-HCO provide additional commentary and illustrations.

The first step in evaluating the reporting of an investment is to determine whether the investee must be consolidated. If the investor has a controlling financial interest, consolidation is required, except in certain situations involving LP investments made by non-healthcare NFPs, as described in the figure below. Because the guidance in ASC 810-10-15 regarding the variable interest model excludes NFPs, the evaluation should be made using the voting interest model.

As discussed in CG 3, under the voting interest model, the usual condition for a controlling financial interest is ownership of over 50 percent of the outstanding voting shares of a corporation. For non-stock investments such as interests in partnerships, trusts, or unincorporated joint ventures, a similar assessment of whether a controlling financial interest exists must be made to decide whether consolidation is required.

The figure below summarizes the consolidation requirements for NFP investments in for-profit entities.

**Figure 6-1**
NFP consolidation requirements – investments in for-profit entities

<table>
<thead>
<tr>
<th>Circumstances</th>
<th>Requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td>The NFP has a controlling financial interest through direct or indirect ownership of a majority voting interest of a for-profit entity.</td>
<td>Consolidate unless control does not rest with the majority owner.</td>
</tr>
<tr>
<td>An NFP is the controlling partner in a general partnership.</td>
<td>By analogy to ASC 970, a general partnership that is directly or indirectly controlled by an investor is, in substance, a subsidiary of the investor and, thus, would be consolidated.</td>
</tr>
<tr>
<td>An NFP that is not a HCO is a general partner in a limited partnership (or partnership-form LLC or similar entity).</td>
<td>If the investment was made in contemplation of generating investment return and the NFP has elected the “portfolio-wide fair value option,” described in ASC 958, report at fair value. If the NFP does not utilize the portfolio-wide fair value option, or if the investee is part of the NFP’s operations (i.e., an operating investment rather than a portfolio investment), consolidate if the NFP holds a controlling financial interest.</td>
</tr>
<tr>
<td>Scenario</td>
<td>Consolidation Rule</td>
</tr>
<tr>
<td>-------------------------------------------------------------------------</td>
<td>-----------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>An NFP HCO is a general partner in a limited partnership (or partnership-form LLC or similar entity).</td>
<td>Consolidate unless the presumption of control by the general partner is overcome.</td>
</tr>
<tr>
<td>An NFP HCO is a limited partner in a limited partnership (or partnership-form LLC or similar entity).</td>
<td>Consolidate if the NFP holds a controlling financial interest.</td>
</tr>
<tr>
<td>The NFP has a majority voting interest in a for-profit entity that is analogous to a corporation (such as an LLC that is the functional equivalent of a regular corporation).</td>
<td>Consolidate.</td>
</tr>
</tbody>
</table>

Some NFPs may also contemplate using arrangements involving related entities that do not require consolidation under the guidance discussed above (e.g., special-purpose entities (SPEs)) in an effort to achieve off-balance-sheet treatment of certain assets and liabilities. ASC 958-810-25-8 through ASC 958-810-25-10, Not-for-Profit Entities: Consolidation—Special-Purpose-Entity Lessors, and related implementation guidance establishes the framework to be applied by NFPs in evaluating SPE leasing relationships for consolidation. An NFP must consolidate an SPE lessor if three specified conditions exist: (1) substantially all of the SPE’s activities involve assets that are to be leased to the lessee; (2) the expected substantive residual risks, substantially all the residual rewards of the leased asset(s), and the obligation imposed by the underlying debt of the SPE directly or indirectly reside with the lessee; and (3) the SPE’s owner of record has not made an initial substantive residual equity capital investment that is at risk during the entire lease term.

ASC 958-840 contains additional information on the NFP SPE leasing framework. FinREC’s views on the investment required by the SPE’s owner of record are discussed in AAG-NFP 3.105 and AAG-HCO 12.55.