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Chapter 2

Who has to consolidate
the special purpose entity?

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In accounting for securitizations, there are two baseline questions to answer:

- Do I have to consolidate the special purpose entity(ies) involved?
- Have I sold the transferred assets for accounting purposes?

Both US Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards® (IFRS) require a reporting entity, as part of the derecognition assessment, to consider whether the transfer represents a transfer to a consolidated subsidiary. Therefore, logically, the first step in determining whether sale accounting has occurred is to determine if the transferor is required to consolidate the securitization entity.

Because many securitizations involve more than one transfer, and consolidated affiliates often prepare their own separate entity financial statements, the consolidation and sale questions will often need to be considered more than once for a transaction. As one might expect, different answers may be appropriate at different stages in the securitization or for different financial reporting purposes, depending on the facts and circumstances.

What accounting guidance applies?

For companies applying GAAP, the consolidation guidance is included in ASC 810, *Consolidation*—in particular, the variable interest entities (VIE) subsections. Not all special purpose entities (SPEs) are VIEs, but generally all securitization SPEs are VIEs. A securitization SPE does not usually issue equity instruments with voting rights (or other interests with similar rights) with the power to direct the activities of the entity, and often the total equity investment at risk is not sufficient to permit the entity to finance its activities without additional forms of credit enhancement or other financial support. If an entity does not issue voting or similar interests or if the equity investment at risk is insufficient, that entity's activities probably are predetermined or decision-making ability is determined contractually. Because securitization entities are typically insufficiently capitalized, with no (or little) true "equity" for accounting purposes, they are generally VIEs. The investments or other interests that will absorb portions of a VIE's expected losses or receive portions of its expected residual returns are called variable interests.

Under GAAP, all legal entities are required to be evaluated as either a VIE or a voting interest entity. The evaluation of whether a VIE should be consolidated is based on whether the reporting entity has both: (1) power and (2) exposure to potentially significant economics.

Under IFRS, the primary source of guidance on determining when and how to prepare *consolidated financial statements* is IFRS 10, Consolidated Financial Statements, which contains a single, control-based model for determining consolidation of a legal entity. In other words, IFRS 10 does not require an analysis of whether a legal entity is a VIE or a voting interest entity.

Who must consolidate the securitization entity?

The first step in determining who should consolidate the securitization entity is identifying all the parties to the transaction and identifying which parties hold variable interests in the SPE. While there is no requirement for the transaction parties to compare their accounting conclusions (theoretically, only one entity, if any, should conclude that it has control), each participant needs to understand the various rights and obligations granted to each party in order to reach its own accounting conclusions for its interest(s) in the SPE.

The consolidation models under both GAAP and IFRS are largely similar and are based on control. ASC 810 requires identifying "the primary beneficiary," which is the party that has a "controlling financial interest" because it has both: (1) the power to direct the activities of a VIE that most significantly impact the VIE's economic performance, and (2) the obligation to absorb losses of the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE. Under IFRS 10, an investor controls an entity if the investor has: (1) power over the investee, (2) exposure, or rights, to variable returns from its involvement with the investee, and (3) the ability to use its power over the investee to affect the amount of the investor's return.



GAAP consolidation decision tree

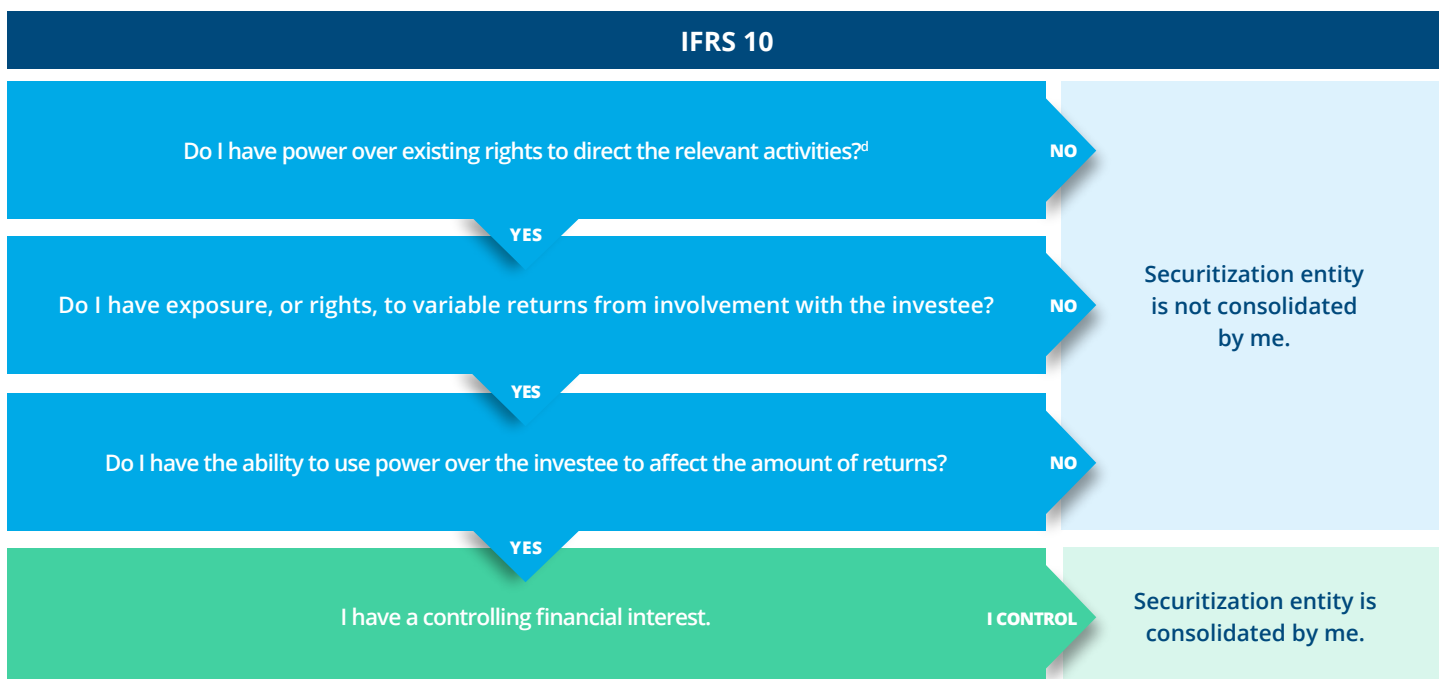


a In addition to their own activities and variable interests, reporting entities must also consider the activities and variable interests of both related parties and those parties deemed de facto agents under ASC 810.

b Some servicing fee and decision-making arrangements may not constitute a variable interest in a VIE, as discussed later in this chapter.

c Indirect interests represent an entity's proportion of interests held by related parties and de facto agents.

IFRS consolidation decision tree



^d In addition to their own activities and variable interests, reporting entities must also consider the activities and variable interests of both related parties and those parties deemed de facto agents under IFRS 10.

ASC 810 provides that only substantive terms, transactions, and arrangements, whether contractual or noncontractual, shall be considered. Judgment, based on consideration of all facts and circumstances, is needed to distinguish substantive terms, transactions, and arrangements from those that are nonsubstantive. James L. Kroeker, the former Securities and Exchange Commission (SEC) chief accountant and former FASB vice chairman, told auditors and preparers "to remain vigilant when evaluating the substance, or lack thereof, of elements of transactions included to achieve specific accounting results" for off-balance-sheet transactions.¹ While not as explicit, IFRS 10 also states that only substantive rights over an investee are considered, and it provides examples of factors to consider in determining whether a right is substantive (such as penalties or incentives that would deter a holder from exercising its rights).

Only one reporting entity is expected to control a securitization entity (or any VIE). Although several transaction participants could have variable interests, typically only one, if any, would have the power to direct the activities that most significantly impact the entity's economic

performance. Further elaboration on interpreting what it takes to have variable interests that are potentially significant under GAAP and the ability to affect returns through power under IFRS is provided later in this chapter.

If a securitization entity must be consolidated, all of its assets and liabilities (to third parties) are included in the consolidated balance sheet of the party that consolidates, not just the party's proportionate ownership share. Interests in a consolidated securitization entity (e.g., beneficial interests) that are held by other investors are presented as liabilities in the consolidated financial statements. That is, even if the beneficial interests are issued in the form of equity (e.g., a share), the SEC staff believes those beneficial interests should be classified as liabilities in the consolidated financial statements of the parent entity.²

It is important to remember that all intercompany transactions, such as servicing or other fee arrangements between the securitization entity and the consolidating entity, have to be eliminated in consolidation.

¹ Chief Accountant James L. Kroeker, Office of the Chief Accountant: "Remarks Before the 2009 AICPA National Conference on Current SEC and PCAOB Developments," AICPA SEC Conference, Washington, DC, December 7, 2009.

² Professional Accounting Fellow Brian Fields, "Speech by SEC Staff: Remarks before the 2009 AICPA National Conference on Current SEC and PCAOB Developments," AICPA SEC Conference, Washington, DC, December 7, 2009.

Step 1: Power—identifying the most important activities

In securitizations, the economic performance of the entity is generally most significantly impacted by the performance of the underlying assets. Sometimes, in structures like commercial paper (CP) conduits, management of liabilities (e.g., selecting the tenor of CP) may also significantly impact the performance of the entity, but generally not most significantly. Some of the factors that could impact the performance of the underlying assets might be beyond the direct control of any of the parties to the securitization (e.g., voluntary prepayments) and therefore do not affect the power analysis. The activity that most significantly impacts the performance of the underlying assets is typically the management by the servicer of the inevitable delinquencies and defaults that occur; or, in a managed collateral loan obligation (CLO), the activities of the collateral manager in selecting, monitoring, and disposing of collateral assets.

When analyzing who has the power to direct those activities, the following questions should be answered:

- Do I hold the power unilaterally?
- Or do other parties also have relevant rights and responsibilities? For example:
 - Is there another party or other parties that direct other important activities of the trust? If so, which activities are the most important?
 - Is there another party that has to consent to every important decision?
 - Is there another party that can direct me to take certain actions?
 - Is there another party that can replace me without cause?
 - Is there another party or other parties that direct the same activities as me but with a different portion of the trust's assets?
- Is my right to exercise power currently available or contingent on some other event(s) occurring?

Kick-out rights (GAAP)/principal-agent (IFRS)

GAAP and IFRS include similar concepts with respect to kick-out or removal rights, but they are framed in slightly different contexts within each respective consolidation model. Substantive kick-out rights (i.e., those that can be exercised at will and not upon a contingent event) held by a single party result in the party performing the relevant activities not having power because it could be removed from that role at the whim of the party holding the removal right.

GAAP incorporates the concept of kick-out or removal rights as part of the power determination. If a single participant has the substantive right to unilaterally remove the party that directs the entity's most significant activities, that right, in and of itself, may indicate that the holder of the kick-out right has power over the securitization entity, but only if that right is substantive and can be exercised at will (e.g., not solely upon an event of an objectively determinable breach of contract or insolvency by the service provider).

A kick-out right would generally be considered substantive if there are no significant barriers to exercise that right. Barriers to exercise include, but are not limited to, the following:

- Conditions that make it unlikely they will be exercisable. For example, conditions that narrowly limit the timing of the exercise.
- Financial penalties or operational barriers associated with replacing the decision-maker that would act as a significant disincentive for removal.
- The absence of an adequate number of qualified replacement decision-makers or the lack of adequate compensation to attract a qualified replacement.
- Lack of a mechanism for the holder to exercise its kick-out right. For example, the right can be exercised only at an investor meeting, but meetings cannot be initiated by the holder.
- The inability of the parties holding the rights to obtain the information necessary to exercise them.

When might a servicer or collateral manager not have power?

| Situation | See related guidance topic |
|-------------------------------------------------------------------------------------------------------|---------------------------------------------------------------|
| The servicer can be replaced without cause by a single unrelated party | Kick-out rights (GAAP)/principal-agent (IFRS) |
| All important servicing decisions require the consent of one or more unrelated parties | Participating rights and shared power |
| The servicer services less than a majority of the assets in the VIE (assuming the assets are similar) | Multiple parties having power |
| The activities of the servicer are administrative in nature and there is a special servicer | Power to direct contingent on other events |

IFRS raises the issue of kick-out rights or removal rights in the determination of whether a party is acting as a principal to a transaction or as an agent on behalf of others (as further discussed later in this chapter). If a single party is able to exercise the kick-out right without cause or barriers, then that fact—in isolation—is indicative of the decision-maker being an agent and not having control.

So how do these concepts apply to securitization structures? It is common in commercial mortgage-backed securities (CMBS) transactions for a controlling classholder, which is defined in the transaction documents as the party that holds the majority of a subordinated class of the issuer's securities, to be able to remove the special servicer in the transaction without cause.

In many cases, the controlling classholder is—or is affiliated with—the special servicer, so this provision would not have an effect on the consolidation analysis in those situations. If a vote of the holders of the subordinated class of the securitization entity's securities was needed in order to replace the service provider, and there was more than one unrelated holder of those securities, then the kick-out right would not—in isolation—be enough to conclude that the special servicer does not have power and control. But if the controlling classholder is a single party (say the primary servicer) that could remove the special servicer at will, then the special servicer would not be deemed to have control. Instead, control lies with the single party that is the controlling classholder. Replacement of a special servicer only upon an objectively determinable breach of contract or insolvency, however, does not provide a party with power.

Participating rights and shared power

Under GAAP, participating rights are the ability to block or participate in the actions through which a reporting entity exercises the power to direct the activities of an entity that most significantly impact the entity's economic performance. Protective rights are rights designed to protect the interests of the party holding those rights without providing that party with control. IFRS does not define participating rights but acknowledges the concept of protective rights and that such rights would not provide power to that party.

So what does that mean? If a single participant (including its related parties) can veto all important decisions made by the unrelated servicer, that right—if considered substantive—might cause the service provider to not have “power,” and power would be shared between the service provider and the participant holding the veto right (unrelated parties). If, in addition to being able to veto servicer decisions, a single participant could direct the servicer on what actions to take on defaulted loans, the consolidation burden might shift to that single participant. It is unusual in securitization transactions for any single participant to have the ability to block servicer actions, other than in certain limited cases, such as when a monoline insurer is paying out losses. That case may reflect a shift in power.

The requirement to obtain consent is considered a substantive participating right when the consent is required for all of the activities that most significantly impact the entity's economic performance. When the consent relates only to activities that are unimportant or only to certain of the significant activities, the consent might be considered a protective right; however, power would not be considered shared. In addition, an enterprise would need to closely analyze the governance provisions of an entity to understand whether the consent requirements are substantive (e.g., the consequences if consent were not given).

Multiple parties having power

The concept of multiple parties having power can manifest itself in two ways:

- ***Multiple parties performing different activities***

It is possible that in certain securitizations, one service provider might be engaged to perform asset management and another service provider to perform funding management. In those situations, one must determine which activity most significantly affects the economic performance of the entity. Judgment will be required based on an analysis of all of the facts and circumstances. This concept is consistent in both the GAAP and IFRS consolidation models.

- ***Multiple parties performing the same activities***

Both GAAP and IFRS have similar concepts that if multiple unrelated parties must jointly consent over decisions related to directing the relevant activities of an entity, power is shared and no party would consolidate. However, ASC 810 includes a concept not specifically addressed in IFRS 10 that when multiple parties individually perform the same activities over separate pools of assets, the party that would consolidate would be the party that has unilateral decision-making over a majority of the assets, assuming that the assets are similar (e.g., assuming that the pool representing the majority of the assets is expected to most significantly affect the economic performance of the entity).

Power to direct contingent on other events

GAAP

When a party can direct activities only upon the occurrence of a contingent event (such as a servicer, who, except for a borrower default, performs only administrative tasks), the determination of which party has power will require an assessment of whether the contingent event initiates the most significant activities of the entity (i.e., the entity's most significant activities only occur when the contingent event happens) or results in a change in power (i.e., power shifts from one party to another upon the occurrence of a contingent event) over the most significant activities of the entity (in addition, the contingent event may change the composition of the entity's most significant activities).

Determining whether the contingent event initiates the most significant activities of the entity or results in a change in power will be based on a number of factors, including:

- The nature of the activities of the entity and its design.
- The significance of the activities and decisions that must be made before the occurrence of the contingent event, compared with the significance of the activities and decisions that must be made once the contingent event occurs. If both sets of activities and decisions are significant to the economic performance of the entity, the contingent event results in a change in power over the most significant activities of the entity. However, if the activities and decisions before the contingent event are not significant to the economic performance of the entity, the contingent event initiates the most significant activities of the entity.

If a transaction participant concludes that the contingent event initiates the most significant activities of the entity, all of the activities of the entity (including the activities that occur after the contingent event) would be included in the evaluation of whether they have the power to direct the activities that most significantly affect the entity's economic performance. In such instances, the party that directs the activities initiated by the contingent event would be the enterprise with the power to direct the activities that most significantly affect the economic performance of the entity.

If the transaction participant concludes that the contingent event results in a change in power over the most significant activities of the securitization entity, the transaction party must evaluate whether the contingency is substantive. This assessment should focus on the entire life of the VIE. Some items to consider in assessing whether the contingent event is substantive include:

- The nature of the activities of the entity and its design.
- The terms of the contracts the entity has entered into with the variable interest holders.
- The variable interest holders' expectations regarding power at inception of the arrangement and throughout the life of the entity.
- Whether the contingent event is outside the control of the entity's variable interest holders.
- The likelihood that the contingent event will occur (or not occur) in the future. This should include, but not be limited to, consideration of the history of whether a similar contingent event in similar arrangements has occurred.

So how about some examples?

In CMBS, and potentially other asset classes, it is common that upon delinquency or default by the borrower—or when default is reasonably foreseeable—the responsibility for servicing of the loan is transferred from the primary servicer to a special servicer. In such cases, the activities that the primary servicer has the power to direct are typically administrative in nature and do not significantly impact the entity's economic performance.

Thus, the primary servicer would not typically have power. But can the special servicer have power even at the outset of the transaction given that there were no loans in special servicing? The answer is yes. Because the activities performed by the primary servicer are not considered significant to the economic performance of the securitization entity, and it is considered likely that the special servicer will be performing services during the life of the securitization entity, the special servicer is considered, from the outset, to have the power to direct the relevant activities. Another important consideration is whether the special servicer can be replaced and by whom. If the primary servicer or another party can unilaterally remove the special servicer, then that party may have power instead.

Another example is that of a monoline insurer, who has guaranteed the senior class of a securitization against losses once all subordinated classes have been written down to zero. In certain transactions, upon the occurrence of such events, the power of the monoline insurer increases in ways such as gaining the ability to replace the servicer or to start directing the servicer in the actions it should take on defaulted loans. The occurrence of the contingent event would likely result in a change in power over the most significant activities of the securitization entity and a change in primary beneficiary.

Yet another example would be the controlling classholder in a securitization entity initially being the holder of the majority of the most subordinated class. However, if losses are such that the subordinated class is reduced below some prespecified level, then the controlling classholder is changed to the holder of the majority of the next senior class (e.g., a mezzanine class). The occurrence of the contingent event might result in a change in power and a change in which party consolidates.

IFRS

IFRS 10 has similar concepts with respect to power upon contingent events and specifically addresses the issue in the context of predetermined activities (see section below for further discussion around predetermined activities). In practice, virtually all structured entities that operate in a predetermined way have relevant activities. Relevant activities are not necessarily activities that require decisions to be made in the normal course of the entity's activities; such decisions may be required only when particular circumstances arise or events occur. A structured entity that operates in a largely predetermined way may be designed so the direction of its activities and its returns are predetermined unless, or until, particular circumstances arise or events occur. In such cases, the decisions about the entity's activities when the specified circumstances or events occur are the relevant activities of the structured entity because they can significantly affect the returns of the structured entity. The fact that the right to make decisions is contingent on particular circumstances arising or an event occurring does not in itself affect the assessment as to whether an investor has power over the structured entity. The particular circumstances or events need not have occurred for an investor with the ability to make those decisions to have power over the structured entity.

Are there situations in which entities will not have ongoing activities that significantly affect their economic performance?

GAAP

In limited situations, the ongoing activities performed throughout the life of a securitization entity, though they may be necessary for the entity's continued existence (e.g., administrative activities in

certain re-securitization entities, such as re-securitizations of real estate mortgage investment conduits [RE-REMICs]), may not be expected to significantly affect the entity's economic performance. In such situations, determination of the primary beneficiary will need to focus on the activities performed and decisions made at the securitization entity's inception as part of the design, because in those situations the initial design had the most significant impact on the economic performance of the entity.

However, when the ongoing activities of a securitization entity are expected to significantly affect the entity's economic performance, a reporting entity will need to focus the power analysis on those ongoing activities.³ That is, it would not be appropriate to determine the primary beneficiary solely on the basis of decisions made at the entity's inception as part of the entity's design when there are ongoing activities that will significantly affect the economic performance of the entity. In addition, as discussed below, an evaluation of involvement in design will generally only be determinative when one reporting entity (or related-party group) has an economic interest that is disproportionately greater than its ongoing, stated power to direct the activities of the securitization entity.

ASC 810-10-25-38F states that an enterprise's involvement in the design of an entity "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 ... the power to direct the activities that most significantly impact [the VIE's] economic performance." However, it also notes that involvement in the design does not, in itself, establish that enterprise as the party with power. In many situations, several parties will be involved in



³ In addition, in certain financial structures, a single reporting entity may have the unilateral ability to liquidate the entity. Such ability may indicate that the reporting entity has the power to direct the activity that most significantly affects the economic performance of the entity.

the design of an entity, and an analysis of the decisions made as part of the design would not be determinative or would not result in the identification of a primary beneficiary. ASC 810-10-25-38G states, in part, that “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.”

Thus, in situations in which the ongoing activities of a securitization entity are not expected to significantly affect the entity’s economic performance and one enterprise (or related-party group) holds an economic interest that is so significant that the other interest holders, as a group, do not hold more than an insignificant amount of the fair value of the entity’s interests or those interests do not absorb more than an insignificant amount of the entity’s variability, it would generally be appropriate to conclude that the enterprise (or an enterprise within the related-party group) with that significant economic interest made the decisions at the inception of the entity or that the decisions were essentially made on the entity’s behalf. Therefore, in such situations, it may be appropriate to conclude—after all facts and circumstances associated with the entity have been considered—that the enterprise (or the enterprise within the related-party group) has a controlling financial interest in the entity.

Note that when the primary beneficiary analysis is based solely on the design of an entity, the determination of whether one enterprise (or related-party group) absorbs all but an insignificant amount of the variability in such entity depends, in part, on a consideration of the entity’s expected losses and expected residual returns. By focusing on expected losses and expected residual returns, a party with a small overall ownership percentage in an entity could be exposed to a significant amount of such entity’s variability (e.g., the holder of a residual interest when there is a large amount of senior interests). Conversely, a party with a large overall ownership percentage in an entity may not be exposed to a significant amount of such entity’s variability (e.g., if the party holds senior interests in an entity whose capitalization also includes substantive subordinated and residual interests). In re-securitizations in which there are multiple underlying asset groups with no cross-collateralization, those determinations are made on a group-by-group basis, because each group would generally be considered a “silo.”

IFRS

Under IFRS 10, the fact that a structured entity operates in a largely predetermined way does not necessarily mean that the entity has no relevant activities. In practice, virtually all structured entities that operate in a predetermined way have relevant activities.

A structured entity operating in a largely predetermined way will most commonly be established to invest in assets that are expected

to provide a predictable level of return with little or no ongoing input from investors. However, decisions outside the predetermined parameters may need to be made when that return fails to materialize, such as the decision on how to pursue recovery in the event of default for a portfolio of mortgage loans. Such decisions significantly affect the returns of the securitization entity and, therefore, are the relevant activities of the entity. Consequently, the analysis of who has power over the securitization entity should focus on the ability to make those decisions.

IFRS 10:BC80 provides an example of a receivables securitization where the primary purpose of the entity is to allocate credit risk to the holders of the beneficial interests.⁴ The design of the entity is such that the only relevant activity that can be directed, which significantly affects the returns of the entity, is managing receivables upon default. An investor that writes a put option on the receivables that is triggered when the receivables default might have the current ability to direct the activities that significantly affect the returns. The design of the entity ensures that the investor has decision-making ability when such decision-making is required. In this scenario, the terms of the put agreement are integral to the overall transaction and the establishment of the investee.

The fact that an investor is involved in the design of an investee does not necessarily mean that the investor has decision-making rights to direct the relevant activities of the investee. Often, several parties are involved in the design of an investee, and the final structure of the investee includes whatever is agreed to by all those parties. Consequently, an investor’s involvement in establishing an investee would not, in isolation, be sufficient evidence to determine that the investor has power over the entity.

However, in those extremely rare situations when there are no decisions to be made on relevant activities after the formation of a structured entity, the initial design of the entity may be the relevant activity that significantly affects the returns of the structured entity. Consequently, in determining whether an investor has power over the structured entity, the activities performed and decisions made as part of the entity’s design at formation should be assessed carefully.

In making that assessment, an investor should consider the significance of its interest in the investee and its involvement in the design of the investee (including an assessment of the scope of its decision-making authority during the design process). The more significant an investor’s: (1) interest and (2) involvement in the design of the investee, the more indicative it is that the investor had the ability and incentive to make decisions for its own benefit and, therefore, that it has power over the investee.

4 Beneficial interests are defined as rights to receive all or portions of specified cash inflows received by a trust or other entity, including, but not limited to, all of the following: (i) senior and subordinated shares of interest, principal, or other cash inflows to be passed through or paid through; (ii) premiums due to guarantors; (iii) commercial paper obligations; and (iv) residual interests, whether in the form of debt or equity.



Step 2: Variable interests in an entity

The second step in the consolidation assessment is very similar under GAAP and IFRS. That step requires consideration of whether an entity is exposed to variable returns. Under both standards, variable returns can include only upside benefit (a performance fee) or downside risk (a guarantee), or both (a debt or equity investment).

Where the models differ is how the variable interest is considered. GAAP simply looks at whether the variable returns have the potential to be significant. IFRS does not directly consider whether the variable interest is significant. Instead, IFRS 10 looks at whether the decision-maker's power can influence its variable returns, and whether that makes the decision-maker a principal to a transaction or just an agent acting on behalf of others. ASC 810 does not include principal/agent guidance⁵ like IFRS 10. Instead, ASC 810 includes a list of criteria to consider in determining whether a fee received by a service provider represents a variable interest in an entity.

Fees paid to decision-makers or service providers (GAAP)

The determination of whether a decision-maker's fee arrangement is a variable interest has a significant impact on the consolidation conclusion. Fees paid to a decision-maker or service provider do not represent a variable interest if all of the following are met:

- The fees are compensation for services provided and are commensurate with the level of effort required to provide those services.
- The decision-maker or service provider does not hold other interests in the securitization entity that individually or in the aggregate would be expected to absorb more than an insignificant amount of the entity's expected losses⁶ or receive more than an insignificant amount of the entity's expected residual returns.
- The service arrangement includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length.

When applying those criteria, the reporting entity is allowed to exclude interests held by certain of its related parties (including de facto agents) when evaluating its economic exposure as part of determining whether, on the basis of its relationship with the related party, its decision-making arrangement represents a variable interest.

Specifically, interests held by a decision-maker's or service provider's related parties (or de facto agents) are only to be included in the evaluation of whether the decision-maker's or service provider's fee arrangement is a variable interest when the decision-maker or service provider has a variable interest in the related party. In those



5 The principal/agent evaluation is integrated within the determination of a variable interest and the primary beneficiary.

6 The quantitative approach described in the definitions of 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.

cases, it would include its economic exposure to the legal entity through its related party 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 legal entity being evaluated, the decision-maker's or service provider's interest would be considered equivalent to an 8 percent direct interest in the legal entity. However, if the decision-maker or service provider did not hold the 20 percent interest in its related party, it would not include any of the related party's interest in its evaluation. If fees do not meet all of the conditions above, then those fees are variable interests, and the decision-maker or service provider, would proceed to the next steps in the GAAP consolidation decision tree presented earlier in this chapter. The decision-maker must also determine whether that variable interest is a variable interest in the securitization entity as a whole, or whether it relates to particular specified assets of the entity. If the variable interest relates to specified assets representing more than half of the total fair value of all of the assets within the securitization entity, or if the decision-maker holds another variable interest in the entity as a whole, then the variable interest would be deemed to be a variable interest in the securitization entity, and the decision-maker or service provider would proceed to the next steps in the same decision tree referenced previously in this chapter.

In addition, fees or other arrangements that expose the decision-maker or service provider to risk of loss in the VIE would not be eligible for evaluation under the three conditions above. Instead, such fees are considered variable interests. Examples include:

- a) Fees 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.

Meaning of "insignificant" in the analysis of fees paid to a decision-maker or service provider

ASC 810-10 does not define the term "insignificant" as used in ASC 810-10-55-37(c). However, as a general guideline, if the expected losses absorbed or expected residual returns received through variable interests (other than the fee arrangement) in

the potential VIE exceed, either individually or in the aggregate, 10 percent of the expected losses or expected residual returns of the VIE, the condition in ASC 810-10-55-37(c) is not met, and the decision-maker or service provider fee would be considered a variable interest. However, because of the subjective nature of the calculation of expected losses and expected residual returns, 10 percent should not be viewed as a bright-line threshold or safe harbor. In light of those considerations, the reporting entity will need to apply professional judgment and assess the nature of its involvement with the VIE.

The analysis under ASC 810-10-55-37(c) deals with the expected outcome of the VIE. Therefore, when analyzing a decision-maker or service provider fee under this criterion, a reporting entity would identify and weigh the probability of the various possible outcomes in determining the expected losses and expected residual returns of the VIE. However, the reporting entity may not be required to prepare a detailed quantitative analysis to reach a conclusion under ASC 810-10-55-37(c). For example, if a decision-maker or service provider holds 100 percent of the residual interest in a legal entity (and the residual interest is substantive), a reporting entity may qualitatively conclude that holding all of a substantive residual interest would represent more than an insignificant amount of the legal entity's expected losses or expected residual returns. Conversely, if a decision-maker holds less than 10 percent of the residual interest in a legal entity, the reporting entity may qualitatively conclude that holding less than 10 percent of the residual interest would not represent more than an insignificant amount of the legal entity's expected losses or expected residual returns.

In accordance with ASC 810-10-25-38H, if fees paid to the decision-maker or service provider are both commensurate and at market,⁷ such fees should not be considered for purposes of the economics test of ASC 810-10-25-38A(b). A reporting entity that does not have a variable interest in a VIE (e.g., the entity's only involvement in the VIE is limited to a fee arrangement that has been determined not to be a variable interest) would never be the VIE's primary beneficiary.

However, if an enterprise determines that a fee paid to a decision-maker or service provider is a variable interest after considering the conditions above, the decision-maker or service provider will need to assess whether its interest represents an obligation to absorb losses of the entity or a right to receive benefits from the entity that could potentially be significant to the entity.

⁷ Specifically, the fees are: (i) compensation for services provided and commensurate with the level of effort required to provide the services and (ii) part of a service arrangement that includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length.

Potentially significant variable interest (GAAP)

ASC 810-10 describes a significant variable interest as one that either obligates the reporting enterprise to absorb losses or provides it with a right to receive benefits from the VIE that could potentially be significant to the VIE. No bright line exists to determine whether the variable interest is significant. Instead, the reporting entity should consider both quantitative and qualitative factors, including:⁸

- The purpose and design of the legal entity.
- Terms and characteristics of the financial interest.
- The reporting entity's business purpose for holding the variable interest.

There may be situations in which a party with a variable interest will not have a right to receive benefits or the obligation to absorb losses of the securitization entity that could potentially be significant to the securitization entity. For example, a service provider's right to receive a fixed fee may represent a variable interest because the fee is not at market, and may not represent a benefit or obligation that could potentially be significant to the entity. While not included in ASC 810, this was discussed in the Basis for Conclusions when Statement of Financial Accounting Standards 167 (FAS 167)⁹ was issued, which noted that the servicer may be able to conclude, on the basis of the magnitude of the fixed percentage, that the fee could never be significant to the entity because the fee would remain a constant percentage of the entity's assets. On the other hand, a fee that was considered insignificant under the criteria discussed above and the implicit probability notion might be considered potentially significant, as further discussed below.

The VIE subsections of ASC 810 do not define "economic performance" but indicate that an enterprise must assess the entity's purpose and design when evaluating the power to direct the activities of the entity. This assessment includes a consideration of all risks and associated variability that are absorbed by any of the entity's variable interest holders. However, the quantitative calculations of expected losses and expected residual returns are not required. An enterprise should not consider probability when determining whether it has a variable interest that could be potentially significant. Therefore, even a remote possibility that an enterprise could absorb losses or receive benefits that could be significant to the entity causes the enterprise to meet such condition.

The evaluation of an enterprise's economic exposure through its interests should take into account the securitization's purpose and design. In addition, all risks and associated variability that are absorbed by any of the securitization entity's variable interest holders should be considered. The type of interest held by an enterprise will affect its economic exposure to the securitization.

For example, a "first-loss" residual interest may be more likely to expose an enterprise to a significant amount of expected losses or the potential to receive significant expected residual returns than a more senior interest.



8 Professional Accounting Fellow Arie Wilgenburg, "Speech by SEC Staff: Remarks before the 2009 AICPA National Conference on Current SEC and PCAOB Developments," AICPA SEC Conference, Washington, DC, December 7, 2009.

9 FASB Statement of Financial Accounting Standards No. 167, Amendments to FASB Interpretation No. 46(R) (June 2009).

Am I a principal or am I an agent to the securitization? (IFRS)

For IFRS, an entity with decision-making rights has to consider whether it is acting as a principal or an agent. Likewise, an investor is required to determine whether another entity with decision-making rights is acting as an agent on behalf of the investor. An investor may delegate its decision-making to an agent on certain specific issues (e.g., a special servicer that handles mortgage defaults) or on all relevant activities (e.g., a mortgage servicer that handles cash collections, distributions to note holders, and mortgage defaults).

A decision-maker is an agent when it is primarily engaged to act on behalf and for the benefit of others (the principal[s]). An agent does not control an investee by exercising its decision-making powers. However, a decision-maker is not an agent simply because other parties can benefit from the decisions that it makes; the decision-maker must also consider its own benefits and risks in determining whether it is truly an agent.

IFRS 10 states that, when a single party holds a substantive right to remove the decision-maker and can remove the decision-maker without cause, this—in isolation—is sufficient to conclude that the decision-maker is an agent. For a removal right to be considered substantive, one must determine that there are no barriers or disincentives to exercise, including consideration of the timing of the removal right. In the absence of single-party kick-out rights, the decision-maker is required to consider the overall relationship between itself, the investee being managed, and *other* parties involved with the investee. Each of the factors that follow below should be considered in making the principal/agent assessment; in certain instances, some factors may be stronger indicators than others and should receive greater weighting in assessing whether a decision-maker is a principal or an agent.

The scope of the decision-maker's authority over the investee

The scope of decision-making authority is evaluated by considering: (1) the activities that are permitted according to the decision-making agreement(s) and specified by law; and (2) the discretion that the decision-maker has when making decisions about those activities. This assessment requires the decision-maker to consider the purpose and design of the securitization entity, the risks to which the securitization entity was designed to be exposed (i.e., credit risk of the securitized asset pool), the risks it was designed to pass on to the parties involved, and the level of involvement the decision-maker had in the design of the investee. IFRS 10 notes that when a decision-maker is significantly involved in the design of the investee (including the determination of the scope of decision-making authority), this may indicate that the decision-maker had the opportunity and incentive to obtain rights that result in the decision-maker having the ability to direct the relevant activities. So what does that mean for securitizations? There generally should not be entities where the decisions are preprogrammed and therefore no one has power. Furthermore, the decision-maker being involved in the design of the securitization entity may indicate the decision-maker is acting in a capacity as a principal to the securitization entity.

The rights held by other parties

Substantive rights held by others may impact the decision-maker's ability to direct the relevant activities of a securitization entity. As mentioned above, if a single party can remove the decision-maker without cause, this—in isolation—is sufficient to conclude that the decision-maker is acting as an agent. If multiple parties are required to act together to remove the decision-maker (e.g., simple-majority

kick-out rights), those rights are not—in isolation—conclusive in determining that a decision-maker acts primarily as an agent. The greater the number of parties required to act together to exercise the kick-out rights, and the greater the size and variability of the decision-maker's other variable interests (i.e., remuneration and other interests), the lower the weighting this factor should receive in the analysis. Substantive rights held by other parties that restrict a decision-maker's ability to exercise its rights (e.g., when a decision-maker is required to obtain approval from a small number of other parties for its actions) should be considered in a manner similar to removal rights. The basis for conclusions of IFRS 10 also notes that some other rights (such as some liquidation rights) may have the same effect on the decision-maker as removal rights. If those other rights meet the definition of removal rights, they should be treated as such regardless of their label.

The remuneration to which the decision-maker is entitled in accordance with the remuneration agreement(s)

The greater the size and variability of the decision-maker's remuneration relative to the expected returns from the securitization entity, the more likely it is the decision-maker is a principal. For a decision-maker to be considered an agent, its remuneration must be commensurate with the services provided and include only market-based terms, conditions, and amounts (unless, of course, single-party kick-out rights exist, and then the other criteria are not relevant). However, these two factors alone are not enough to make one an agent. The purpose of this requirement is to consider whether the remuneration for the decision-maker is truly compensation solely for its services as an agent.

The decision-maker's exposure to variability of returns from other interests that it holds in the investee

A decision-maker that holds other interests in a securitization entity (e.g., the super senior tranche or the equity tranche) should consider its exposure to variability of returns in assessing whether it is an agent. Holding other interests in the securitization entity indicates that the decision-maker may be acting as a principal. In evaluating its exposure to variability of returns from other interests, the decision-maker should consider: (1) the greater the size and variability of its economic interests (including its remuneration and other interests in aggregate), the more likely the decision-maker is a principal; and (2) whether its exposure to variability is different from other investors and, if so, whether this might influence its decision-making. This may be the case when the decision-maker holds subordinated interests in a securitization entity, or provides other forms of credit enhancement such as a liquidity facility to a CP conduit. The decision-maker should evaluate its exposure relative to the total variability of returns of the securitization entity, primarily based on returns expected from the activities of the entity, but also not ignoring the decision-maker's maximum exposure to variability of returns through other interests that the decision-maker holds.

The IFRS 10 determination of whether a decision-maker is a principal or an agent can require judgment. As noted above, in the evaluation of the aforementioned factors, some factors may be stronger indicators than others and should receive greater weighting in assessing whether a decision-maker is a principal or an agent.

Related-party considerations

In performing the primary beneficiary analysis, a reporting entity must carefully consider related-party relationships. A reporting entity that concludes individually that it has not met both the power criterion and the economics criterion may still be required to consolidate a VIE as a result of interests held by its related parties. The term "related parties" includes certain other parties that are acting as de facto agents or de facto principals of the reporting entity. Both GAAP and IFRS require consideration of involvements of related parties or de facto agents in the consolidation assessment.

A reporting entity is always required to assess whether it individually meets both characteristics (the power criterion and the economics criterion) of a primary beneficiary after considering the guidance in the aggregation of interests for evaluating the economics criterion section below. If a reporting entity concludes that it does not meet the criteria for a primary beneficiary, but the related-party group (including de facto agents) meets the criteria as a group, the reporting entity may be required to determine which party is most closely associated with the VIE and is required to consolidate the VIE.

It is noteworthy that at the 2014 AICPA National Conference on Current SEC and PCAOB Developments the SEC staff discussed whether

related parties under common control are always required to perform the related-party tiebreaker test to determine whether stated power is substantive. The SEC staff noted that while entities must carefully consider situations involving related parties under common control to determine whether stated power is substantive, "the staff does not believe there is a requirement to consider the related party tiebreaker guidance or that [such] guidance is necessarily determinative unless no party in the common control group individually meets both characteristics of a primary beneficiary."¹⁰

When evaluating whether a single decision-maker that meets the power criterion also meets the economics criterion, the reporting entity must consider its direct interests and indirect interests (i.e., those held through its related parties and de facto agents) in the VIE. If the single decision-maker meets the economics criterion through its direct interests, it is not necessary to further consider its indirect interests. The reporting entity would only consider its related party's or de facto agent's interests in the determination of whether it has met the economics criterion if the reporting entity has an interest in the related party. If the reporting entity does not have a direct interest in the related party, it would not be appropriate to attribute the related party's interests to the reporting entity.

Under ASC 810, if a single reporting entity is not identified as the primary beneficiary, additional analysis to identify the entity that is "most closely associated" with the VIE is required in the two following scenarios:

- A single decision-maker does not meet the economics criterion directly, or indirectly through its interests in related parties or de facto agents, but together with its related parties that are under common control, it possesses both characteristics of a controlling financial interest.
- Two or more related parties or de facto agents share power over the relevant activities and collectively hold potentially significant economic interests.

If either of those scenarios occur, then an assessment is performed to determine which party within the specified related-party group is considered most closely associated with the entity and therefore should consolidate. ASC 810 provides the following four criteria to consider in making this assessment:

- The existence of a principal-agency relationship between parties within the related-party group.
- The relationship and significance of the activities of the entity to the various parties within the related-party group.
- A party's exposure to the expected losses and/or residual returns of the entity.
- The design of the entity.

¹⁰ Professional Accounting Fellow Christopher F. Rogers, Office of the Chief Accountant, "Remarks before the 2014 AICPA National Conference on Current SEC and PCAOB Developments," December 8, 2014.



IFRS 10 is less prescriptive when it comes to related parties or de facto agents, requiring that when assessing control, consideration should be given to the nature of the relationships with other parties and whether those parties are acting on the investor's behalf.

Aggregation of interests for evaluating the economics criterion

In evaluating whether the economics criterion has been met, a decision-maker would consider only interests held by its related parties (including de facto agents) if the decision-maker has a direct interest in those related parties. Those interests would be considered on a proportionate basis (e.g., if the reporting entity owned 20 percent of a related party that, in turn, owned 10 percent of the VIE, the reporting entity would have a 2 percent indirect interest in the VIE). In contrast, if the decision-maker does not hold an interest in its related parties, it would not include any of its related parties' interests in its evaluation. In addition, a reporting entity should generally consolidate a VIE if: (1) the reporting entity is a related party to a single decision-maker that does not, individually, have both characteristics of a controlling financial interest, (2) no other party in the related party group is required to consolidate the VIE, and (3) substantially all of the activities of the VIE either involve or are conducted on behalf of the reporting entity.

Reconsideration of who controls

The VIE guidance in ASC 810 requires that an enterprise continually reconsider its conclusion regarding which interest holder is the entity's primary beneficiary. A change in the determination of whether an entity is required to consolidate could occur as a result of any of the following events or circumstances:

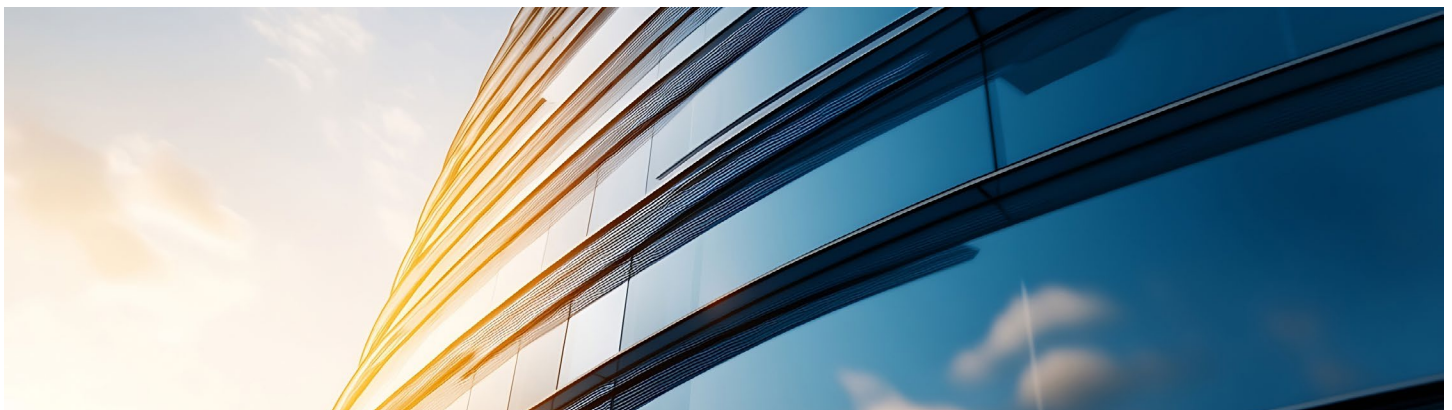
- There is a change in the design of the entity (e.g., a change in the governance structure or management, a change in the activities or purpose of the entity, or a change in the primary risks that the entity was designed to create and pass through to variable interest holders).
- The entity issues additional variable interests or retires or modifies the terms of the variable interests.
- There is a change in the counterparties to the variable interests of the entity (e.g., a reporting entity acquires or disposes of variable

interests in a VIE, and the acquired or disposed-of interest, in conjunction with the reporting entity's other involvement with the entity, causes the reporting entity to gain or lose the power to direct the activities that most significantly affect the entity's economic performance).

- A significant change in the anticipated economic performance of an entity (e.g., as a result of losses significantly in excess of those originally expected for the entity) or other events (including the commencement of new activities by the entity) result in a change in the reporting entity that has the power to direct the activities that most significantly affect the entity's economic performance.
- Two or more variable interest holders become related parties or are no longer considered related parties, and such a related party group has (had) both the power to direct the activities of the entity and the obligation (right) to absorb losses (benefits) that could potentially be significant to the entity, but neither related party individually possesses (possessed) both characteristics.
- A contingent event occurs that transfers the power to direct the activities of the entity that most significantly affect an entity's economic performance from one reporting entity to another reporting entity.

Because continual reconsideration is required, the securitization transaction participant may need to determine when, during the reporting period, the change in primary beneficiary occurred. If a deal party determines that it is no longer the primary beneficiary of a securitization entity, it would need to deconsolidate from the date that the circumstances changed and recognize a gain or loss.

Similarly, IFRS 10 requires an investor to reassess whether or not it controls an investee when facts and circumstances indicate that there are changes to one or more of the three elements of control. IFRS 10:B85 states that an "investor's initial assessment of control or its status as a principal or an agent would not change simply because of a change in market conditions (e.g., a change in the investee's returns driven by market conditions), unless the change in market conditions changes one or more of the three elements of control ... or changes the overall relationship between a principal and an agent."



Contacts



Authors

Lakshmanan (Bala) Balachander

Consulting Services Principal | Deloitte & Touche LLP
+1 212 436 5340
lbalachander@deloitte.com

William Fellows

Audit & Assurance Partner | Deloitte & Touche LLP
+1 718 508 6888
wfellows@deloitte.com

Michelle Markowitz

Tax Managing Director | Deloitte Tax LLP
+1 713 982 4265
mmarkowitz@deloitte.com

Rishin Pandya

Consulting Services Managing Director | Deloitte & Touche LLP
+1 312 486 7585
ripandya@deloitte.com

Andrew Pidgeon

Audit & Assurance Partner | Deloitte & Touche LLP
+1 415 783 6426
apidgeon@deloitte.com

Greg Sobreiro

Audit & Assurance Managing Director | Deloitte & Touche LLP
+1 212 436 2487
gsobreiro@deloitte.com

Contributors

In memoriam:

James Cahalan

Managing Director | Deloitte & Touche LLP

Cara Bhalla

Audit & Assurance Senior Manager | Deloitte & Touche LLP
+1 703 251 1475
cbhalla@deloitte.com

Christy Bihm

Audit & Assurance Managing Director | Deloitte & Touche LLP
+1 203 761 3110
cbihm@deloitte.com

Elisa Esposito

Audit & Assurance Managing Director | Deloitte & Touche LLP
+1 212 436 4216
eesposito@deloitte.com

Aadarsh Malayil

Consulting Services Senior Consultant | Deloitte & Touche LLP
+1 212 436 4570
amalayil@deloitte.com

Christie Murphy

External Communications QRM Support Specialist Manager |
Deloitte & Touche LLP
+1 313 394 5017
christimurphy@deloitte.com



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