

CONTROL AND CONSOLIDATION UNDER ASC 810 — AN INDUSTRY SUPPLEMENT TO A BDO BLUEPRINT

Physician Practice Management Entities

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BDO

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1. Introduction

Physician practice management entities (PPMEs), sometimes referred to as "management services organizations" (MSOs), emerged in the 1980s and 1990s in response to the growing complexity of healthcare administration and the need for more efficient practice management. These companies provide a range of services, including billing, human resources, compliance, and IT support, allowing physicians to spend more time focusing on patient care. The popularity of PPMEs was driven by the desire for investors to consolidate physician practices to achieve economies of scale, improve negotiating power with payors, and enhance operational efficiencies.

In recent years, there has been a resurgence of interest in PPMEs fueled by advancements in technology, regulatory changes, and the increasing administrative burdens on healthcare providers. This renewed interest has been significantly bolstered by private equity (PE) investment. Many PE firms are attracted to the healthcare sector because of its growth potential. PPMEs can be used as vehicles to achieve scalable growth and improved efficiencies through consolidation and professional management.

However, PPMEs face regulatory challenges. For example, many states enforce strict corporate practice of medicine laws that limit or prohibit non-physician ownership of medical practices. These laws are designed to ensure that medical decisions are made by licensed physicians rather than businesses. As a result, PPMEs (which are often owned by non-physician investors) must understand and comply with these laws. Further, because the laws vary by state, a PPME that wants to operate in multiple jurisdictions must navigate a myriad of regulations.

Some PPMEs solely provide administrative services (in exchange for a fee) to support physicians that want to maintain control of their practices. If the arrangement does not give the PPME control of the practice, it is accounted for under Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 606, *Revenue From Contracts With Customers*.

Other PPMEs and physician practices execute management services arrangements that are more complex. Such contracts may give the PPME the right to make some significant decisions (other than medical decisions) on behalf of the physician practices. These arrangements need to be analyzed to determine whether the PPME controls and consolidates the physician practice under ASC 810, *Consolidation*, or if it must apply other applicable U.S. GAAP (such as ASC 606) to account for its arrangements.

For example, to navigate corporate practice of medicine restrictions, PPMEs often use a nominee shareholder structure (see Section 3.3.1.2), which is sometimes referred to as a "friendly physician model." In this model, the PPME appoints a licensed physician (the nominee shareholder who holds the equity of the physician practice) to be responsible for all significant decisions. However, the PPME maintains power over the physician practice because it has the right to appoint another physician to replace the nominee shareholder without cause.

If a PPME determines that it controls a physician practice, it must consolidate the physician practice beginning at the date it obtains control (which can also be referred to as the "acquisition date"). Typically, a physician practice meets the definition of a business, and its initial consolidation is accounted for in accordance with ASC 805, *Business Combinations* (see Sections 5.1 and 5.2.1).

However, a PPME also may acquire specific assets without obtaining control of the entire physician practice. In such cases, the PPME must determine whether the acquired assets meet the definition of a business. If they do, the PPME accounts for the acquisition as a business combination; if they do not, the PPME accounts for the transaction as an asset acquisition (see Section 5.2.2). If a PPME does not control a physician practice, it typically accounts for its contract under ASC 606 (see BDO's Blueprint, **Revenue Recognition Under ASC 606)**.

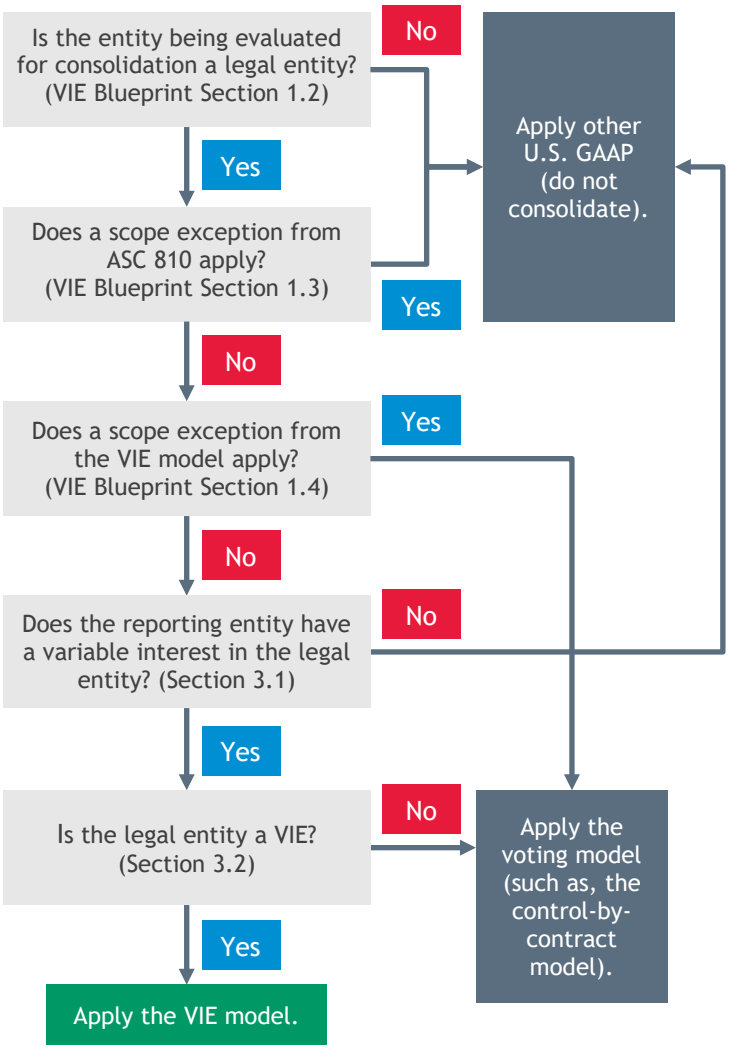
Occasionally, the initial consolidation of a physician practice occurs because of a common control transaction. In such cases, the initial consolidation is recognized at the ultimate parent entity's carryover basis (see Section 5.3).

ABOUT THIS PUBLICATION

This publication provides guidance for evaluating whether a PPME controls, and therefore must consolidate, a physician practice, as well as the guidance for the initial and subsequent accounting by the PPME. It should be read in connection with BDO's Blueprints, **Control and Consolidation Under ASC 810** (VIE Blueprint), and **Business Combinations Under ASC 805.** The accounting for each PPME's contractual arrangements with physician practices varies based on the facts and circumstances of each contract and, therefore, might differ from the examples and insights in this publication.

2. Scope

When a PPME becomes involved with a physician practice, it must apply the guidance in ASC 810 to determine whether it must consolidate the practice. As shown in the flowchart, a PPME (reporting entity) first determines whether the PPME and physician practice (legal entity) are in the scope of the consolidation guidance in ASC 810. The PPME then determines whether the reporting entity and legal entity are in the scope of the variable interest entity (VIE) model. If so, the PPME applies that model. If the legal entity is in the scope of the consolidation guidance but outside the scope of the VIE model, it is a voting interest entity, and the reporting entity uses the guidance in the general subsections of ASC 810 (specifically, the voting model, including the control-by-contract model) to determine whether it controls the voting interest entity.



The term "legal entity" refers to any legal structure used to conduct activities or hold assets such as a corporation, partnership, limited liability company (LLC), professional limited liability company (PLLC), professional association (PA), or trust (see Section 1.2 of BDO's Blueprint, Control and Consolidation Under ASC 810). This publication uses the term "legal entity" to refer to the entity being evaluated for potential consolidation (the physician practice), and the term "reporting entity" to refer to the entity evaluating the legal entity for potential consolidation (the PPME).

Because corporate practice of medicine laws generally limit or prohibit non-physician ownership of a physician practice, a PPME may enter a management services agreement that is broader than just providing administrative services to the physician practice. As such, any decision-making rights held by a PPME are typically conveyed through a contractual arrangement rather than ownership of the equity of the physician practice. Because of that, nearly all physician practices to which a PPME provides management services must be evaluated to determine whether they are VIEs.

Before the advent of the VIE model, a PPME would apply EITF 97-2,[1] which has been codified in the *Consolidation of Entities Controlled by Contract* subsections of ASC 810, to determine whether it must consolidate a physician practice. However, since the VIE model was introduced, the guidance on legal entities controlled by contract rarely applies for a PPME because PPMEs and physician practices do not typically qualify for any of the scope exceptions to the consolidation guidance or VIE model (see Sections 1.3 through 1.4 of BDO's Blueprint, Control and Consolidation Under ASC 810). See Section 4 of this publication for a discussion of the control-by-contract model.

If a PPME enters a services agreement with a physician practice that is not operating within a legal entity (such as a sole practitioner), the arrangement is not within the scope of the consolidation guidance. These arrangements are accounted for under ASC 606 (see BDO's Blueprint, Revenue Recognition Under ASC 606).

[1] EITF 97-2, *Application of FASB Statement No. 94 and APB Opinion No. 16 to Physician Practice Management Entities and Certain Other Entities With Contractual Management*.

3. Applying the VIE Model

In the VIE model, a PPME is the primary beneficiary and has a controlling financial interest in a VIE if it has power and economics.

Power	Power is the ability to direct the activities that most significantly impact the VIE's economic performance (see Section 3.3.1).
Economics	Economics is the obligation to absorb the VIE's losses or the right to receive benefits from the VIE that **could** potentially be significant to the VIE (see Section 3.3.2).

A physician practice (legal entity) is a VIE if it has **any** of the following characteristics:

- The equity at risk is insufficient to finance the legal entity's activities without additional subordinated financial support (see Section 3.2.1).
- The holders of the equity at risk collectively lack the power, through voting rights or similar rights, to direct the activities that significantly impact the legal entity's economic performance (see Section 3.2.2).
- The holders of the equity at risk collectively lack the obligation to absorb the legal entity's expected losses (see Section 3.2.3).
- The holders of the equity at risk collectively lack the right to receive the legal entity's expected residual returns (see Section 3.2.4).
- The voting rights are nonsubstantive (the legal entity fails the anti-abuse test) (see Section 3.2.5).

3.1 IDENTIFY VARIABLE INTERESTS

To apply the VIE model, a reporting entity (the PPME) must determine whether it has a variable interest in the legal entity (the physician practice). ASC 810-10-20 defines variable interests as "*contractual, ownership, or other pecuniary interests in a VIE that change with changes in the fair value of the VIE's net assets exclusive of variable interests.*" A share of common stock is the simplest example of a variable interest. As the fair value of the legal entity's net assets increases or decreases, the common stock absorbs that change and increases or decreases in fair value.

A legal entity's assets and activities generally **create** variability and thus are not variable interests, while its liabilities and equity generally **absorb** variability and therefore are variable interests held by those resource providers. Other contracts or arrangements, such as derivatives, are sometimes assets and sometimes liabilities. The role of a contract or arrangement in the legal entity's design dictates whether an interest creates or absorbs variability, regardless of its legal form or accounting classification. Sometimes, determining whether an interest or arrangement is a variable interest is straightforward. At other times, the determination requires the application of professional judgment based on the facts and circumstances.

A reporting entity uses two steps to determine whether an interest or arrangement is a variable interest.

Step 1: Analyze the nature of the risks in the legal entity (Section 2.2.1 of the VIE Blueprint) → Step 2: Determine the legal entity's purpose and the variability it is designed to create and pass along to its interest holders (Section 2.2.2 of the VIE Blueprint)

In Step 1, a reporting entity analyzes the nature of the legal entity's risks (for example, credit risk, equity price risk, and operations risk). Identifying the risks to which a legal entity is exposed requires the application of professional judgment based on the facts and circumstances.

In Step 2, the reporting entity gains an understanding of the legal entity's purpose, and, based on that purpose and the risks in the legal entity, the reporting entity determines the variability the legal entity was designed to create and pass along to its interest holders. Formation documents, governing documents, marketing materials, and other contracts given to investors and other parties involved with the legal entity provide information about the entity's purpose and design.

Variability is the difference from the expected outcome for the change in fair value of the legal entity's net assets. Expected variability refers to amounts derived from expected cash flows (the probability-weighted average of possible future cash flows) and can be positive (expected residual returns) or negative (expected losses). Negative variability can occur without a history of losses and without anticipating a net loss in any of the expected outcomes. Even a profitable legal entity has expected losses. A reporting entity generally can qualitatively identify which factors contribute to the expected variability based on the legal entity's purpose and design. Although ASC 810 illustrates a quantitative approach for calculating expected losses and expected residual returns, a qualitative approach generally suffices (see Section 2.2 of BDO's Blueprint, Control and Consolidation Under ASC 810).

Variable interests can be explicit or implicit. This table lists examples of **potential explicit** variable interests that often exist for physician practices (it is not intended to be exhaustive).

POTENTIAL VARIABLE INTERESTS	GUIDANCE
Fees paid to a decision maker or service provider	Section 3.1.1
Equity instruments (including some call options on equity)	Section 3.1.2
Debt and beneficial interests	Section 3.1.3
Guarantees	Section 3.1.4
Leases	Section 3.1.5

CONSOLIDATION ANALYSIS STOPS IF PPME DOES NOT HAVE A VARIABLE INTEREST

If a PPME does not have an explicit or implicit variable interest in a physician practice entity, it cannot be the primary beneficiary, and its consolidation analysis stops.

3.1.1 Fees Paid to a Decision Maker or Service Provider

FASB REFERENCES

ASC 810-10-20: Decision Maker, ASC 810-10-55-37 through 55-38, and ASC 810-10-55-205L through 55-205Y

ASC 810-10-55-37

> *Fees paid to a legal entity's decision maker(s) or service provider(s) are not variable interests if all of the following conditions are met:*
>
> > *a. The fees are compensation for services provided and are commensurate with the level of effort required to provide those services.*

> *b. Subparagraph superseded by Accounting Standards Update No. 2015-02.*
>
> *c. The decision maker or service provider does not hold other interests in the VIE that individually, or in the aggregate, would absorb more than an insignificant amount of the VIE's expected losses or receive more than an insignificant amount of the VIE's expected residual returns.*
>
> *d. The service arrangement includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length…*

Fees paid to a PPME as a decision maker or service provider may be variable interests if they absorb the variability that the legal entity was designed to distribute. In many cases the decision maker fees are the only variable interest the PPME has in a physician practice. 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.*"

Fees paid to a decision maker or service provider are **not** variable interests if **all** the following conditions are met:

- The service arrangement includes only terms, conditions, and amounts customarily present in arrangements for similar services negotiated at arm's length (see Section 3.1.1.1).
- The fees are compensation for services provided and commensurate with the level of effort to provide those services (see Section 3.1.1.1).
- The decision maker or service provider does not hold other interests in the legal entity that would absorb more than an insignificant amount of the legal entity's expected variability (see Section 3.1.1.2).
- The decision maker or service provider is not exposed to risk of loss (see Section 3.1.1.3).



Fees paid to a decision maker or service provider that do not meet **all** the conditions above are variable interests. However, if the fees are not variable interests, the decision maker or service provider functions as an agent or fiduciary of the variable interest holders and cannot be the legal entity's primary beneficiary. In other words, the consolidation analysis stops for the PPME.

BDO INSIGHT 3-1: FEE ARRANGEMENTS

In our experience, fee arrangements with PPMEs that are designed to solely provide administrative services are typically customary and commensurate (see Section 3.1.1.1) because the fees are designed only to compensate the PPMEs for the administrative services they provide, and they do not expose the PPME to risk of loss (see Section 3.1.1.3). If that is the case, and the PPME does not hold other interests in the legal entity that individually or in the aggregate **would** absorb more than an insignificant amount of the legal entity's expected variability (see Section 3.1.1.2), the fees paid to the PPME would not be variable interests.

However, many fee arrangements with PPMEs are variable interests because the fees are not customary and commensurate (see Section 3.1.1.1) or because the PPME is exposed to risk of loss (see Section 3.1.1.3).

If a PPME's fees are not variable interests, and the PPME does not have other variable interests that would cause it to control and consolidate the physician practice, the PPME generally would apply ASC 606 to account for the fee arrangement (see BDO's Blueprint, Revenue Recognition Under ASC 606).

3.1.1.1 Customary and Commensurate

FASB REFERENCES

ASC 810-10-55-37(a), ASC 810-10-55-37(d), and ASC 810-10-55-37B



A PPME must determine whether fees it receives are customary and commensurate to assess whether the fees are variable interests. That determination also is relevant when identifying a VIE's primary beneficiary because fees that are customary and commensurate and do not expose the decision maker to risk of loss are excluded when evaluating whether a party has economics (see Section 4.3.3 of BDO's Blueprint, Control and Consolidation Under ASC 810).

BDO INSIGHT 3-2: FEE ARRANGEMENTS

In our experience, fee arrangements with PPMEs that are designed to solely provide administrative services are typically customary and commensurate because the fees are designed only to compensate the PPMEs for the administrative services they provide. If that is the case, and the PPME does not hold other interests in the legal entity that individually or in the aggregate **would** absorb more than an insignificant amount of the legal entity's expected variability (see Section 3.1.1.2) or expose the PPME to risk of loss (see Section 3.1.1.3), the fees paid to the PPME are **not** variable interests.

However, fee arrangements with PPMEs that provide decision-making rights to the PPME are often structured in a manner that is not customary and commensurate with a normal fee arrangement for a service provider. For example, in return for an upfront payment to a selling physician, a PPME may be entitled to receive a management fee that is more than the value of the management services it provides or has terms that would be unusual for a normal service provider. For example, in some arrangements, the physician practice is required to distribute all (or substantially all) of its operating income to the PPME. We believe that fee arrangements designed to absorb substantially all the residual returns of the physician practice cannot be customary and commensurate because they take on the characteristics of equity in those circumstances, even if similar arrangements exist in the market.

Also, as part of the decision-maker fee arrangement, PPMEs that use a nominee shareholder structure (see Section 3.3.1.2) typically have a right to remove and replace the nominee shareholder without cause. If the PPME exercises this right, the replacement shareholder typically must purchase the outstanding equity interests of the nominee shareholder for a small amount (such as $1,000). We believe this right could be viewed as part of the decision-maker fee arrangement. If so, we believe the right is not customary for an arrangement designed solely to compensate a PPME for the services it provides.

When evaluating whether fee arrangements are customary and commensurate, the PPME must consider the characteristics of the fee arrangement.

CHARACTERISTICS MORE LIKELY TO BE CUSTOMARY AND COMMENSURATE	CHARACTERISTICS UNLIKELY TO BE CUSTOMARY AND COMMENSURATE
▶ Agreements are shorter-term and cancelable by the physician practice without cause.	▶ Agreements are longer-term and noncancelable by the physician practice without cause.
▶ Fees approximate fair value of the administrative services provided.	▶ Fees are above fair value of the administrative services provided.
▶ Fees are not designed to transfer most or all the physician practice's profits to the PPME such that substantive profits are expected to be attributed to the equity holders after the fees are paid.	▶ Fees are designed to transfer most or all the physician practice's profits to the PPME such that little or no profits are expected to be attributed to the equity holders after the fees are paid.
▶ PPME cannot remove and replace the equity holder.	▶ PPME can remove and replace the equity holder (nominee shareholder structure).

Fee arrangements that are not customary and commensurate are variable interests. Evaluating whether fees are customary and commensurate requires the application of professional judgment based on the facts and circumstances.

Example 3-1 illustrates a decision-maker fee that is not customary and commensurate.

EXAMPLE 3-1: DECISION-MAKER FEE THAT IS NOT CUSTOMARY AND COMMENSURATE

FACTS

- A PPME purchases the economic rights to a physician practice for cash and enters into several agreements with the physician practice.
- The PPME executes a 10-year management services agreement with a physician practice that specifies the following rights and responsibilities:
  - The PPME will prepare annual operating and capital budgets, which must be approved by the physician practice. The practice can change and approve budgets without the PPME's approval.
  - The PPME will assist the physician practice in evaluating and negotiating contracts with payors, providers, vendors, suppliers, and other third parties, but all contracts must be approved and executed by the practice. In other words, the physician practice can approve and execute contracts without the PPME's approval.
  - The PPME will provide specified equipment to the physician practice.
  - The PPME will neither control nor direct the licensed professionals in the performance of medical services for patients, and all clinical decisions are to be made by the licensed professionals and the physician practice.
  - The PPME will provide all nonclinical administrative services.
- The PPME contemporaneously executes an agreement that allows it to remove and replace the selling physician at any time without cause, with no substantive barriers to exercising this right. If the PPME replaces the selling physician, the new nominee shareholder must buy the exiting nominee shareholder's equity for $1,000.
- The fee for the management services agreement is designed to transfer most of the practice income (after expenses) to the PPME. Also, the PPME has an obligation to fund the physician practice's losses. Neither party has the right to terminate the PPME contract without cause.
- The physician practice has insufficient equity at risk and is a VIE.
- The PLLC operating agreement for the physician practice states that the physician equity owner makes the practice decisions.

CONCLUSION

The PPME has a variable interest because its management fees are not customary and commensurate, and they expose the PPME to risk of loss. See Example 3-5 for further analysis of this arrangement.

ANALYSIS

The management fee payable to the PPME is a decision-maker or service provider fee that must be analyzed to determine whether it is a variable interest.

- Because the fee arrangement is designed to transfer most of the practice income to the PPME, it is not customary for an arrangement that is meant solely to provide services to another entity. The arrangement also is not commensurate with the level of effort to provide those services. We believe that fee arrangements designed to absorb substantially all the residual returns of the physician practice cannot be customary and commensurate because they take on the characteristics of equity in those circumstances, even if similar arrangements exist in the market.
- The fee arrangement exposes the PPME to risk of loss because it requires the PPME to fund the physician practice's losses.

3.1.1.2 Other Interests

FASB REFERENCES

ASC 810-10-55-37(c), ASC 810-10-55-37D, and ASC 810-10-55-96 through 55-109

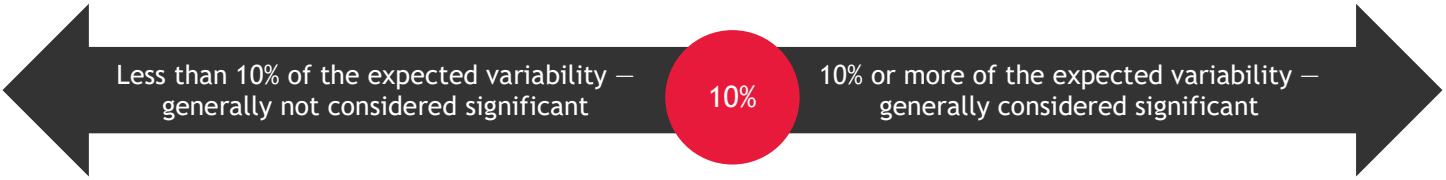


PPMEs may have other variable interests in the physician practice as a result of loans (see Section 3.1.3) to the physician entity, guarantees (see Section 3.1.4), call options (see Section 3.1.2.1), or other arrangements. When evaluating whether fees are variable interests, a PPME evaluates its other interests in the practice. Other interests include direct or implicit interests the PPME holds in the physician practice, and indirect interests held through a related party or de facto agent (see Section 3.4).

If the PPME does not hold other interests in the physician practice that individually or in the aggregate **would** absorb more than an insignificant amount of the practice's expected variability, **and** the fees meet the other conditions, the fees paid to the PPME are **not** variable interests.

The phrase "more than insignificant" is not defined in ASC 810, but it generally means "significant." This evaluation focuses on scenarios that **would** be expected and the physician practice's expected **variability** (which often differs from net income).

There are no bright lines. However, practice has generally considered significance as shown in the following graphic:



See Section 2.3.8.2 of BDO's Blueprint, Control and Consolidation Under ASC 810, for more guidance for evaluating other interests held by a decision maker or service provider.

3.1.1.3 Exposure to Risk of Loss

FASB REFERENCES

ASC 810-10-55-37C



Fee arrangements that expose a PPME to risk of loss cause the fees to be variable interests, even if the fees are otherwise customary and commensurate and the PPME does not have other interests that would absorb more than an insignificant amount of the physician practice's expected variability.

Examples of arrangements that expose a decision maker or service provider to losses include:

- Guarantees of the value of the physician practice's assets or liabilities
- Obligations to fund the practice's operating losses
- Payments for written put options on the physician practice's assets
- Liquidity commitments or similar obligations (explicit or implicit) that protect other variable interest holders from suffering losses in the practice

BDO INSIGHT 3-3: FEE ARRANGEMENTS

In our experience, fee arrangements that provide decision-making rights to the PPME are often structured to expose the PPME to risk of loss. For example, the PPME may agree (explicitly or implicitly) to provide all funding for the physician practice (which creates an obligation to fund the practice's losses) in return for the right to receive all or (or substantially all) practice income (after expenses). Fee arrangements that expose the PPME to risk of loss are variable interests (see Example 3-1).

3.1.2 Equity Instruments

FASB REFERENCES

ASC 810-10-55-22

Equity generally is a variable interest because it is an ownership interest in the legal entity whose value generally absorbs changes in the fair value of the legal entity's net assets. Many states prohibit PPMEs from owning physician practices. As a result, for most physician practices, the equity interests are held by one or more physicians rather than by a PPME. The physicians who hold the equity of the physician practice have variable interests in that entity if it absorbs changes in the fair value of the legal entity's net assets. However, if the equity interests do not absorb variability, they would not be a variable interest. For example, a nominee shareholder's equity may not absorb variability, in which case it would not be a variable interest. See Section 3.3.1.2 for a discussion of the nominee shareholder structure.

3.1.2.1 Call Options on the Legal Entity's Equity

FASB REFERENCES

ASC 810-10-55-22 and ASC 810-10-55-29

While a call option on a legal entity's equity generally is not equity at risk (because it does not participate significantly in both profits and losses), the call option generally is a variable interest if its exercise price is at other than fair value.

'FAIR VALUE' IS NOT ALWAYS FAIR VALUE

A reporting entity may negotiate an exercise price intended to approximate fair value. The exercise price might be expressed as a formula and might even be referred to or defined as "fair value" in the agreement. However, such a formula is considered other than fair value because the value of the underlying might change over time compared to the stated formula.

BDO INSIGHT 3-4: EVALUATING CALL OPTIONS RELATED TO PHYSICIAN PRACTICES

If a PPME or another party has an option to purchase the equity of the physician practice for an amount other than fair value, that option is a variable interest as it absorbs variability of the physician practice.

Also, PPMEs that use a nominee shareholder structure (see Section 3.3.1.2) typically have the right to remove and replace the nominee shareholder without cause. If the PPME exercises this right, the replacement shareholder typically must purchase the outstanding equity interests of the nominee shareholder for a small amount (such as $1,000). We believe this right could be viewed as part of the decision-maker fee arrangement (see Section 3.1.1). If so, we believe this right is not customary for an arrangement designed solely to compensate a PPME for the services it provides. As such, the PPME's decision-maker fee in a nominee shareholder arrangement is a variable interest. Alternatively, we believe that the right to remove and replace the nominee shareholder may result in an implicit variable interest held by the PPME because it enables the PPME to receive additional income by replacing the nominee shareholder to improve the performance of the physician practice, if needed.

3.1.3 Debt and Beneficial Interests

FASB REFERENCES

ASC 810-10-55-23 through 55-24

Physician practices may have debt financing provided by a third party, the PPME, or a physician owner. ASC 810 states that 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.*"

BDO INSIGHT 3-5: DEBT GENERALLY IS A VARIABLE INTEREST

We believe almost all debt issued by a physician practice is a variable interest because it generally absorbs some of the physician practice's expected losses (that is, a decrease in the fair value of the physician practice's net assets). We believe reaching a different conclusion would be rare and would require the application of professional judgment based on the facts and circumstances (for example, evidence that it is the most senior debt and is rated as investment-grade by a ratings agency).

3.1.4 Guarantees

FASB REFERENCES

ASC 810-10-55-25 through 55-26

In some cases, the PPME or the physician owners may provide guarantees to other stakeholders (such as lenders). Guarantees of the value of a physician practice's assets or liabilities absorb variability (and therefore are variable interests) if they protect other interest holders in the physician practice from suffering losses if the physician practice defaults on its obligations (that is, the guarantor must perform or pay if losses occur). The size of the premium or fees received by the guarantor is one indicator of the risk expected to be absorbed by the guarantor. Conversely, if the legal entity writes a guarantee, the guarantee creates variability and therefore is not a variable interest in the legal entity.

Counterparty guarantees the legal entity's obligations or assets	The guarantee absorbs variability. ▶ If the guarantee relates to obligations of the legal entity, it generally is a variable interest, for the same reasons debt is a variable interest (see Section 3.1.3). In addition, a guarantee of the legal entity's debt will often result in the legal entity being a VIE, as discussed in Section 3.2.3. ▶ If the guarantee relates to assets, the reporting entity determines whether the guarantee is an interest in specified assets or a variable interest in that entity as a whole (see Section 2.4 of BDO's Blueprint, Control and Consolidation Under ASC 810).
Legal entity is the guarantor	▶ The guarantee creates variability in the legal entity because it exposes the legal entity to risks if it must perform or pay. Therefore, the guarantee is **not** a variable interest in the guarantor legal entity. However, the legal entity needs to evaluate whether it has a variable interest in the counterparty that it is guaranteeing. ▶ A legal entity's (or its subsidiary's) guarantee of its own debt is not a variable interest because a legal entity cannot guarantee its own performance.

As discussed in Section 2.6 of BDO's Blueprint, Control and Consolidation Under ASC 810, an implicit variable interest exists when a reporting entity **indirectly** absorbs a legal entity's expected variability because of other arrangements, relationships, or facts and circumstances. In some cases, a PPME may have a variable interest in a physician practice as a result of an implicit guarantee if the PPME could be compelled (for example, to protect its reputation or because of other facts and circumstances) to absorb the physician practice's losses to protect another variable interest holder, such as a lender.

Example 3-2 illustrates a PPME that has an implicit variable interest.

EXAMPLE 3-2: PPME HAS AN IMPLICIT VARIABLE INTEREST

FACTS

- A PPME purchases the economic rights to a physician practice for cash and enters into several agreements with the physician practice.
- The PPME executes a 10-year management services agreement with a physician practice that specifies the following rights and responsibilities:
  - The PPME will prepare annual operating and capital budgets which must be approved by the physician practice. The practice may change and approve budgets without the PPME's approval.
  - The PPME will assist the physician practice in evaluating and negotiating contracts with payors, providers, vendors, suppliers, and other third parties, but all contracts must be approved and executed by the physician practice. In other words, the physician practice may approve and execute contracts without the PPME's approval.
  - The PPME will provide certain equipment to the physician practice.
  - The PPME will neither control nor direct the licensed professionals in the performance of medical services for patients, and all clinical decisions shall be made by the licensed professionals and the physician practice.
  - The PPME will provide all nonclinical administrative services.
- The PPME contemporaneously executes an agreement that allows the PPME to remove and replace the selling physician at any time without cause, with no substantive barriers to exercising this right. If the PPME replaces the selling physician, the new nominee shareholder must buy the exiting nominee shareholder's equity for $1,000.
- The fee for the management services agreement is designed to transfer most of the practice's income (after expenses) to the PPME. Neither party has the right to terminate the PPME contract without cause.
- The management services agreement does not explicitly require the PPME to fund the losses of the physician practice. However, the PPME rebranded the physician practice to be consistent with its other clinics and has a past practice of funding other clinics that have experienced losses. Therefore, there is a reasonable expectation that the PPME would fund any losses to protect itself from reputational risk.
- The physician practice has insufficient equity at risk and is a VIE.
- The PLLC operating agreement for the physician practice states that the physician equity owner makes the practice decisions.

CONCLUSION

The PPME has an explicit variable interest because its management fees are not customary and commensurate. Also, the PPME has an implicit variable interest because there is a reasonable expectation that the PPME would be required to fund the physician practice's losses.

ANALYSIS

The management fee payable to the PPME is a decision-maker or service provider fee that must be analyzed to determine whether it is a variable interest.

- Because the fee arrangement is designed to transfer most of the income of the physician practice to the PPME, the arrangement is not customary for an arrangement that is solely meant to only to provide services to another entity nor is it commensurate with the level of effort to provide those services. We believe that fee arrangements designed to absorb substantially all the residual returns of the physician practice cannot be customary and commensurate because they take on the characteristics of equity in those circumstances, even if similar arrangements exist in the market. Therefore, the fee arrangement is an explicit variable interest.
- Although the fee arrangement does not explicitly require the PPME to fund the physician practice's losses, there is a reasonable expectation that the PPME would fund any losses to protect itself from reputational risk. As such, the PPME has an implicit variable interest.

3.1.5 Leases

A physician practice may enter leasing arrangements with its physicians, the PPME, or other parties. Section 2.3.6 of BDO's Blueprint, Control and Consolidation Under ASC 810 provides information about evaluating leasing arrangements.

3.2 IDENTIFYING A VARIABLE INTEREST ENTITY

Once a reporting entity (the PPME) determines that it has a variable interest in a legal entity (physician practice) in the scope of the VIE model, it next determines whether the practice is a VIE. If a physician practice is not a VIE, the PPME evaluates whether it controls the practice in accordance with the voting model, including the control-by-contract model (see Section 4).

Identifying which model to apply is important because the models can result in different consolidation conclusions. The usual condition for a controlling financial interest in a legal entity is ownership of a majority voting interest. However, that condition is not effective in identifying a controlling financial interest for some legal entities. The VIE model is designed to identify legal entities structured so that the equity holders do not have the normal risks, rewards, and decision-making rights that generally belong to equity holders. Therefore, a reporting entity must apply the VIE model if the physician practice has **any** characteristics of a VIE listed in the table below.

CHARACTERISTIC		GUIDANCE
Equity at risk	The equity at risk is insufficient to finance the legal entity's activities without additional subordinated financial support.	Section 3.2.1
Power	The holders of the equity at risk **collectively** lack the power, through voting rights or similar rights, to direct the activities that most significantly impact the legal entity's economic performance.	Section 3.2.2
Expected losses	The holders of the equity at risk **collectively** lack the obligation to absorb the legal entity's expected losses.	Section 3.2.3
Expected residual returns	The holders of the equity at risk **collectively** lack the right to receive the legal entity's expected residual returns.	Section 3.2.4
Voting rights are nonsubstantive (anti-abuse test)	The voting rights are nonsubstantive because **both** criteria below are met: ▶ The voting rights of some investors are not proportional to their economic exposure to the legal entity. ▶ Substantially all the legal entity's activities involve or are conducted on behalf of an investor with disproportionately fewer voting rights, including that investor's related parties and specific de facto agents.	Section 3.2.5

ASC 810 does not require a PPME to evaluate the VIE characteristics in sequence. If a physician practice appears to have one characteristic of a VIE, it might be more efficient to evaluate that characteristic first because the physician practice is a VIE if it has any characteristic of a VIE. On the other hand, for a physician practice to be a voting interest entity, it **cannot have any** VIE characteristics (the PPME must evaluate all five VIE characteristics).

A PPME determines whether a physician practice is a VIE when it first becomes involved with the practice. After the initial determination, the PPME reassesses whether the physician practice is a VIE only upon reconsideration events (see Section 3.6). A physician practice does not become a VIE solely because it incurs losses that reduce its equity at risk. That said, losses that reduce the equity at risk can increase the likelihood of a reconsideration event (for example, renegotiating the fee arrangement). Therefore, a PPME should develop processes and internal controls over financial reporting to monitor changes in facts and circumstances that could affect the analysis.

3.2.1 Insufficient Equity at Risk



FASB REFERENCES

ASC 810-10-20: Subordinated Financial Support, Expected Losses

ASC 810-10-15-14

> *A legal entity shall be subject to consolidation under the guidance in the Variable Interest Entities Subsections if, by design, any of the following conditions exist. (The phrase by design refers to legal entities that meet the conditions in this paragraph because of the way they are structured. For example, a legal entity under the control of its equity investors that originally was not a VIE does not become one because of operating losses. The design of the legal entity is important in the application of these provisions.)…*
>
> *a. The total equity investment (equity investments in a legal entity are interests that are required to be reported as equity in that entity's financial statements) at risk is not sufficient to permit the legal entity to finance its activities without additional subordinated financial support provided by any parties, including equity holders. For this purpose, the total equity investment at risk has all of the following characteristics:*
>
> *1. Includes only equity investments in the legal entity that participate significantly in profits and losses even if those investments do not carry voting rights*
>
> *2. Does not include equity interests that the legal entity issued in exchange for subordinated interests in other VIEs*
>
> *3. Does not include amounts provided to the equity investor directly or indirectly by the legal entity or by other parties involved with the legal entity (for example, by fees, charitable contributions, or other payments), unless the provider is a parent, subsidiary, or affiliate of the investor that is required to be included in the same set of consolidated financial statements as the investor*
>
> *4. Does not include amounts financed for the equity investor (for example, by loans or guarantees of loans) directly by the legal entity or by other parties involved with the legal entity, unless that party is a parent, subsidiary, or affiliate of the investor that is required to be included in the same set of consolidated financial statements as the investor.*

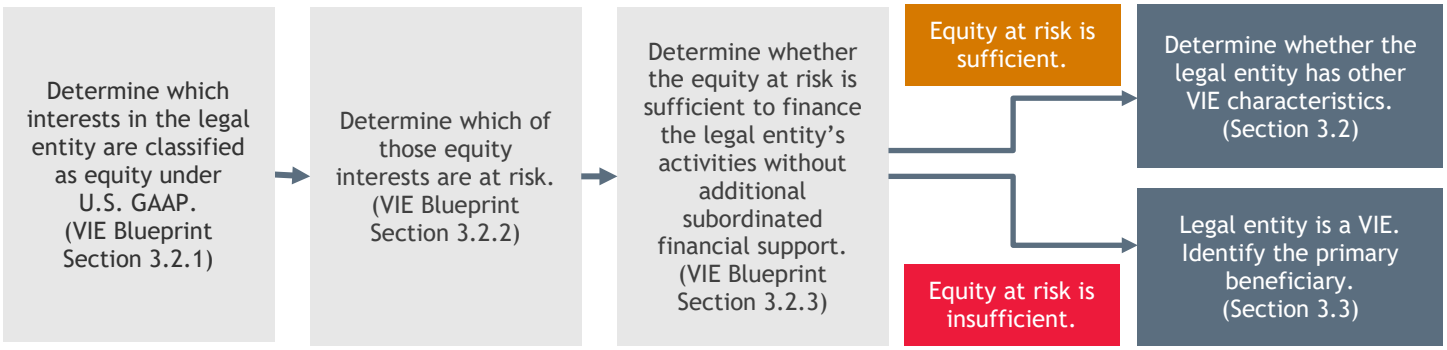
Paragraphs 810-10-25-45 through 25-47 discuss the amount of the total equity investment at risk that is necessary to permit a legal entity to finance its activities without additional subordinated financial support.

 **Equity at risk**	A legal entity is a VIE if the equity at risk is insufficient to finance the legal entity’s activities without additional subordinated financial support.

Subordinated financial support is a variable interest that "*will absorb some or all of a variable interest entity's (VIE's) expected losses.*" Expected losses are "*the expected negative variability in the fair value of [the legal entity's] net assets exclusive of variable interests*" (see Section 2.2.2.1 of BDO's Blueprint, Control and Consolidation Under ASC 810).

Subordinated financial support includes equity instruments, most debt (see Section 3.1.3), contractual agreements with off-market terms (for example, fees that expose the service provider to risk of loss, as discussed in Section 3.1.1.3), guarantees (see Section 3.1.4), and explicit or implicit commitments to fund the physician practice. Subordinated financial support generally excludes senior debt with an investment-grade credit rating (or, if not rated, with similar characteristics) that exposes the creditor to a minimal risk of default.

To determine whether a legal entity has insufficient equity at risk, a reporting entity can follow the flowchart below.



If the equity at risk is insufficient for the physician practice to finance its activities without additional subordinated financial support, the practice is a VIE, as summarized in the graphic below. This can be determined qualitatively or quantitatively (see Section 3.2.3 of BDO's Blueprint, Control and Consolidation Under ASC 810).

Fair value of equity at risk > expected losses	→	Equity at risk is sufficient (the legal entity does not have this characteristic of a VIE); determine whether the legal entity has any other VIE characteristics.
Fair value of equity at risk < expected losses	→	Equity at risk is insufficient (the legal entity is a VIE); identify the primary beneficiary.

There is a rebuttable presumption that equity at risk of less than 10% of the legal entity's total assets is insufficient for the legal entity to finance its activities without additional subordinated financial support. However, some legal entities need equity at risk of more than 10% of their assets to finance their activities, especially if they engage in high-risk activities, hold high-risk assets, or are exposed to risks not reflected in the measurements in the financial statements. Also, asset-light businesses such as physician practices might also require equity at risk of more than 10% of those assets. Therefore, having more equity at risk than 10% of total assets does not necessarily mean the legal entity has sufficient equity at risk.

BE CAREFUL BEFORE RELYING ON THE 10% THRESHOLD

Parties often incorrectly assume that if the legal entity has more than 10% of equity at risk, the equity at risk is automatically sufficient. However, that was not the FASB's intent. The FASB referenced a 10% threshold to demonstrate that the 3% threshold previously applied was insufficient for most VIEs.

Some legal entities may require equity at risk of more than 10%. Therefore, equity at risk greater than 10% is not a safe harbor and does not relieve a PPME of its responsibility for determining whether the physician practice has sufficient equity at risk.

Therefore, a PPME must determine whether the practice's equity is sufficient regardless of whether equity at risk is more or less than 10% of a physician practice's assets.

The below items may qualitatively indicate the equity at risk is insufficient.

 Non-investment-grade debt and complex debt structures	When qualitatively evaluating whether the equity at risk is sufficient, a PPME evaluates the amounts, credit ratings, interest rates, maturity dates, redemption features, contingent interest features, and other terms of the debt, as well as the practice's capital structure. If a physician practice has debt that does not have an investment-grade credit rating (or, if not rated, similar characteristics), it may have insufficient equity at risk. In our experience, most debt issued by a physician practice does not typically have characteristics of an investment-grade credit rating.
 Guarantees	A financial guarantee given on the physician practice's behalf as a condition for a loan likely indicates that the lender believes the practice has insufficient equity at risk to secure repayment. Similarly, if the physician practice can get financing only with recourse to assets held by another entity, or another party guaranteed the value of the practice's assets, that likely indicates the physician practice has insufficient equity at risk.
 Commitments to fund equity or losses	An explicit or implicit commitment by investors to fund equity (for example, buy more shares or fund capital calls) or the physician practice's losses may indicate the practice has insufficient equity at risk. However, a commitment by investors to fund equity in the future does not automatically mean the physician practice has insufficient equity at risk. The PPME must consider the practice's purpose and design (see Section 2.2.2.2 of BDO's Blueprint, Control and Consolidation Under ASC 810). For example, a commitment by the physician owners to fund additional equity so that the physician practice can expand its activities or locations or acquire other physician practices in the future may not indicate insufficient equity at risk based on the legal entity's current purpose and design. On the other hand, if a physician practice needs additional subordinated financial support to finance its current purpose and design (for example, because all the residual earnings are distributed to the PPME through the management fee), the PPME's commitment to fund future losses would likely indicate the practice has insufficient equity at risk. In our experience, PPMEs often have explicit or implicit commitments to fund the losses of physician practices, particularly when the agreements use the nominee shareholder structure (see Section 3.3.1.2).

ASC 810 gives two contrasting examples:

- If a legal entity does not have a limited life and tightly constrained activities, if no unusual arrangements are designed to provide subordinated financial support, if its equity does not appear to be designed to require other subordinated financial support, and if it obtained commercial financing on customary terms, the equity at risk is likely sufficient.
- If a legal entity has a very small equity investment relative to other entities with similar activities and has outstanding subordinated debt that effectively is a replacement for equity, the equity at risk generally is insufficient.

BDO INSIGHT 3-6: PHYSICIAN PRACTICES OFTEN HAVE INSUFFICIENT EQUITY AT RISK

Physician practices are often VIEs because they have insufficient equity at risk. For example, physician practices often have at least one of the following characteristics:

- Subordinated debt arrangements, including debt guaranteed by the PPME or a physician.
- Decision-maker fees that are not customary and commensurate (because the decision maker is entitled to substantially all the practice's residual returns) and that expose the PPME to risk of loss.
- Explicit or implicit commitments from a physician or PPME to fund the physician practice.
- A nominal amount of equity (such as $1,000) with a small fair value (such as when a PPME has the right to receive the majority of the practice's residual returns).
- A nominee shareholder (see Section 3.3.1.2) that does not have equity at risk because (for example):
  - The equity was funded by the PPME or the physician practice.
  - The equity does not participate significantly in profits and losses (such as when fees are designed to provide the PPME with substantially all the practice's residual returns).

Determining whether a physician practice has insufficient equity at risk requires the application of professional judgment based on the facts and circumstances.

3.2.2 Holders of Equity at Risk Collectively Lack Power

FASB REFERENCES

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

> *A legal entity shall be subject to consolidation under the guidance in the Variable Interest Entities Subsections if, by design, any of the following conditions exist.…*
>
> *a. 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…*
>
> *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.*

Power

A legal entity is a VIE if the holders of the equity at risk **collectively** lack the power, through voting rights or similar rights, to direct the activities that most significantly impact the legal entity's economic performance.

The power characteristic must be assessed for the holders of the equity at risk **as a group.** A legal entity is not a VIE simply because an **individual** holder of equity at risk lacks power, as long as the holders of the equity at risk **collectively** have power. However, if decisions are made other than through the equity at risk (for example, a nonequity holder has a variable interest and the right to veto or participate in decisions about the activities that most significantly impact the legal entity's economic performance), the legal entity might be a VIE.

SEPARATE DECISION-MAKING RIGHTS CAN CAUSE A LEGAL ENTITY TO BE A VIE

When evaluating whether the holders of the equity at risk collectively lack power, the reporting entity considers only decision-making rights conveyed **through** the equity at risk. A legal entity may be a VIE if decision-making rights are conveyed through equity that is not at risk or through a contract (and such rights are not contingent on holding equity at risk). A legal entity is a VIE even if those decision-making rights are held by an investor that also holds equity at risk.

For example, an equity investor might also hold debt whose terms give the debt holder substantive veto rights over the activities that most significantly impact the legal entity's economic performance. Because the veto rights are not conveyed through the equity at risk, the holders of the equity at risk collectively lack power, even though the debt holder also holds equity at risk. Therefore, the legal entity is a VIE.

BDO INSIGHT 3-7: PHYSICIAN PRACTICES OFTEN ARE VIES BECAUSE THE EQUITY HOLDERS LACK POWER

Physician practices that outsource decision-making to PPMEs over any activities that most significantly impact the physician practice's economic performance are VIEs if the fee is a variable interest (see Section 3.1.1) and if the holders of equity at risk do not have substantive kick-out rights over the decision maker (PPME).

Reaching a conclusion about whether the PPME has power requires the application of professional judgment based on the facts and circumstances.

3.2.2.1 Evaluating Corporations and Similar Entities

FASB REFERENCES

ASC 810-10-20: Decision Maker

ASC 810-10-15-14(b)(1)(i)

A legal entity shall be subject to consolidation under the guidance in the Variable Interest Entities Subsections if, by design, any of the following conditions exist….

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.*

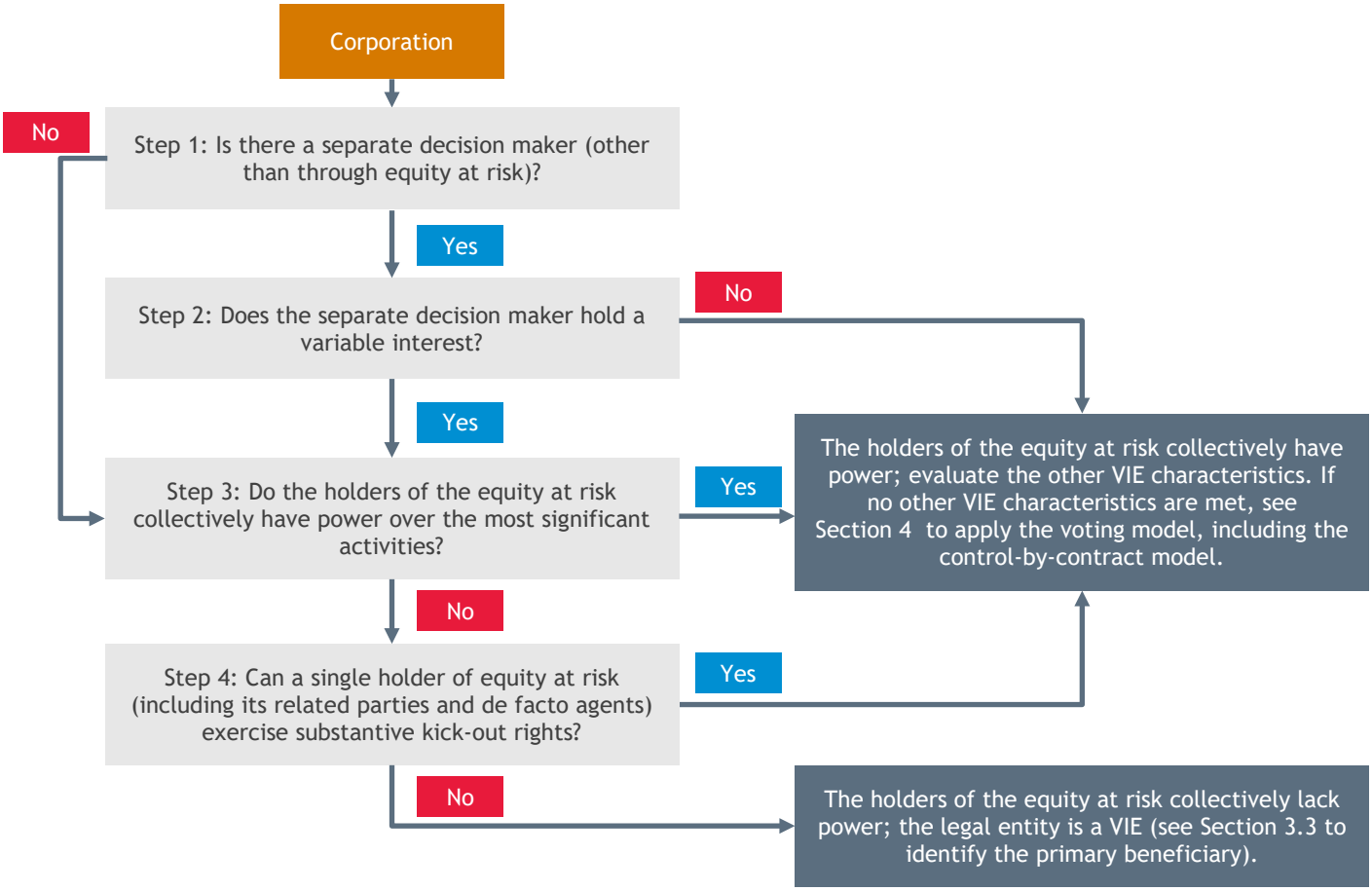
***01**. If no owners hold voting rights or similar rights (such as those of a common shareholder in a corporation) over the activities of a legal entity that most significantly impact the entity's economic performance, **kick-out rights** or **participating rights** (according to their VIE definitions) 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.*
>
> *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.*

When the physician practice is a corporation or similar entity, the evaluation of whether the holders of the equity at risk collectively lack power focuses on whether voting rights or similar rights held through the equity at risk allow the holders to direct the activities that most significantly impact the physician practice's economic performance. This evaluation is consistent with how power is assessed when identifying a VIE's primary beneficiary (see Section 3.3.1) and requires the application of professional judgment based on the facts and circumstances.

Sometimes, a party other than a holder of equity at risk, such as the PPME, is a decision maker, or "*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*." When a PPME has the right to direct **any** of the activities that most significantly impact the physician practice's economic performance through a variable interest that is not equity at risk, the physician practice is a VIE unless the holders of the equity at risk can remove the PPME without cause.

The flowchart below shows the steps for determining whether the holders of a corporation's equity at risk collectively lack power.



The table below summarizes considerations for the steps in the flowchart.

STEP	CONSIDERATIONS
Step 1: Is there a separate decision maker (other than through equity at risk)?	▶ The governing body of a corporation can outsource decision-making rights to a party through a separate agreement (a separate decision maker, such as the PPME). If the PPME has the right to direct at least one of the activities that most significantly impacts the physician practice's economic performance (see Section 3.2.2.1.1), proceed to Step 2. If there is not a separate decision maker, proceed to Step 3. ▶ If the PPME holds equity in the physician practice, reaching a conclusion about whether decision-making rights are contingent on holding equity at risk (and therefore considered part of the equity) requires the application of professional judgment based on the facts and circumstances.

STEP	CONSIDERATIONS
Step 2: Does the separate decision maker hold a variable interest?	▶ If the PPME does not have a variable interest, the holders of the equity at risk are deemed to collectively have power (ASC 810-10-15-14(b)(1)(i)(01)). When fees paid to a PPME are not variable interests (see Section 3.1.1), the PPME is presumed to act as an agent on the equity holders' behalf. In that case, the physician practice does not have the power characteristic of a VIE. Determine whether the physician practice has other VIE characteristics. ▶ If the PPME has a variable interest, proceed to Step 3.
Step 3: Do the holders of the equity at risk collectively have power over the most significant activities?	▶ The holders of the equity at risk collectively have power if no other parties (such as the PPME) have decision-making rights or substantive participating rights (see Section 3.2.2.1.3). That power can be held by the holders of the equity at risk through voting rights (directly), through rights to appoint the physician practice's board of directors (if one exists that votes on such activities), or through other similar rights. When the holders of the equity at risk collectively have power, determine whether the physician practice has other VIE characteristics. ▶ A separate decision maker (such as a PPME) does not prevent the holders of the equity at risk from having power if the holders collectively have substantive kick-out rights exercisable without cause (see Section 3.2.2.1.2). ▶ If a variable interest holder (such as a PPME whose fee is a variable interest) has decision-making rights or substantive participating rights other than through equity at risk, the holders of the equity at risk collectively lack power. The physician practice is a VIE.
Step 4: Can a single holder of equity at risk (including its related parties and de facto agents) exercise substantive kick-out rights?	▶ If a single holder of equity at risk (including its related parties and de facto agents) can exercise substantive kick-out rights (see Section 3.2.2.1.2), the physician practice does not have the power characteristic of a VIE. Determine whether the physician practice has other VIE characteristics.

PARTICIPATING RIGHT HELD BY A PARTY THAT DOES NOT HAVE EQUITY AT RISK

If a party holds substantive participating rights other than through equity at risk, the legal entity is a VIE. For example, if the physician equity holders and the PPME must agree on some of the decisions over activities that most significantly impact the physician practice's economic performance, the holders of the equity at risk collectively lack power and the legal entity is a VIE.

3.2.2.1.1 Identifying a Separate Single Decision Maker and the Significant Activities

FASB REFERENCES

ASC 810-10-15-14(b)(1) and ASC 810-10-20: Decision Maker, Decision-Making Authority

When evaluating whether a corporation or similar entity has the power characteristic of a VIE, once a reporting entity analyzes the nature of the risks in the legal entity and determines the legal entity's purpose and the variability it was designed to create and pass along to its interest holders (see Section 3.1), the PPME must determine which activities most significantly impact the physician practice's economic performance. A party with decision-making authority over any of those activities is a decision maker.

A physician practice generally has many activities, but only a subset of those activities most significantly impacts the legal entity's economic performance. To identify such activities, a PPME considers which activities most significantly impact the physician practice's revenues, expenses, operating margins, cash flows, and other key performance indicators.

The right to make a decision that arises only in exceptional circumstances (outside the physician practice's purpose and design) does not affect whether the entity is a VIE. Identifying the activities that most significantly impact a physician practice's economic performance requires the application of professional judgment based on the facts and circumstances. The physician practice activities below may significantly impact the practice's economic performance if such activities are expected as part of its purpose and design (the list is illustrative, not determinative).

- Approving operating and capital expenditure budgets
- Approving payor contracts (such as, contracts with insurance companies or government payors)
- Setting patient care policies
- Hiring, firing, and compensating physicians and nurses
- Executing provider contracts (contracts with those providing medical care to patients other than the physician equity owner(s))
- Making decisions about patient care (medical decisions)

The right to direct administrative functions, such as administration of contracts, accounting, or tax filings, are **not** activities that most significantly impact a legal entity's economic performance.

CONSIDERING THE LEGAL ENTITY'S PURPOSE AND DESIGN IS IMPORTANT

While the activities above often most significantly impact a physician practice's economic performance, the significant activities for a specific physician practice depend on the practice's purpose and design.

BDO INSIGHT 3-8: DETERMINING WHETHER A PPME IS A DECISION MAKER

When decision-making is delegated to a PPME through an agreement other than equity at risk, the PPME must determine whether it is:

- A decision maker (as defined in ASC 810: *"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"*), in which case, it has power (if it has a variable interest and there are no substantive kick-out rights or participating rights).
- A service provider that is merely executing its role in the context of decisions made by others or performing administrative activities (for example, filing tax returns), in which case, it is not a decision maker.

Making that determination can be challenging. It requires considering what parameters and monitoring activities the holders of the equity at risk put in place for delegated decision making. The scope of such parameters (that is, whether they are broad or narrow, high or low level) and the frequency and consequences of the monitoring could indicate whether the other party is a decision maker or is managing the physician practice in the context of others' decisions.

The scenarios below illustrate these concepts further.

- A physician equity owner executes a management service agreement that gives a PPME broad decision-making authority over several significant activities, including approving budgets and executing payor contracts. The PPME is a decision maker because it has the right to make the decisions about activities that most significantly impact the legal entity's economic performance.
- A physician equity owner executes a service agreement to outsource administrative functions to a PPME. As part of the agreement, the PPME also assists the physician equity holder with negotiating payor contracts, which must be approved or executed by the physician. If the PPME's decisions and activities are constrained by the physician equity owner, the PPME might not be a decision maker because it might not have the right to make decisions about the activities that most significantly impact the physician practice's economic performance.

Reaching a conclusion about whether a PPME is a decision maker requires the application of professional judgment.

3.2.2.1.2 Kick-Out Rights When Evaluating a Corporation

FASB REFERENCES

ASC 810-10-15-14(b)(1)(i)(01) and ASC 810-10-20: Kick-Out Rights (VIE Definition), With Cause, Without Cause

When the physician practice is a corporation or similar entity, the evaluation of whether the holders of the equity at risk collectively lack power focuses on whether the voting rights or similar rights allow the holders of the equity at risk to direct the activities that most significantly impact the physician practice's economic performance. When a party such as a PPME has the right to make these decisions through a variable interest other than equity at risk, but the holders of the equity at risk collectively have substantive kick-out rights, the physician practice is not a VIE under the power characteristic. If a single party holds the kick-out right, that party would have power over the physician practice.

When making this assessment for a corporation, the VIE definition of kick-out rights is used: "*the ability to remove the entity with the power to direct the activities of a VIE that most significantly impact the VIE's economic performance or to dissolve (liquidate) the VIE without cause*." Kick-out rights must be substantive (see Section 3.3.4.1 of BDO's Blueprint, **Control and Consolidation Under ASC 810**) and exercisable without cause to be considered in the evaluation.

Without cause	Without cause means that no reason need be given for the dissolution (liquidation) of the corporation or removal of the decision maker.
With cause	With cause generally restricts the holder's ability to dissolve (liquidate) the corporation or remove the decision maker in situations that include, but that are not limited to, fraud, illegal acts, gross negligence, and bankruptcy of the decision maker.

Rights to liquidate or dissolve the corporation collectively are referred to as "liquidation rights." As discussed in paragraph BC49 of ASU 2015-02, a reporting entity treats liquidation rights like kick-out rights if the holder(s) have the substantive right to liquidate a corporation without cause.

See Section 3.3.1.2 for a discussion of kick-out rights as a result of a nominee shareholder structure.

3.2.2.1.3 Participating Rights When Evaluating a Corporation

FASB REFERENCES

ASC 810-10-15-14(b)(1)(i)(01); ASC 810-10-20: Participating Rights (VIE Definition), Protective Rights (VIE Definition); and ASC 810-10-25-13

When the physician practice is a corporation or similar entity, the evaluation of whether the holders of the equity at risk collectively lack power focuses on whether the voting rights or similar rights allow the holders of the equity at risk to direct the activities that most significantly impact the legal entity's economic performance. When a variable interest holder other than a holder of equity at risk has the substantive right to participate in making (or vetoing) these decisions, it prevents the holders of the equity at risk from collectively having power. The VIE definition of participating rights is used to make this assessment for a corporation or similar entity.

VARIABLE INTEREST ENTITY DEFINITION

Participating Rights	*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 must be substantive (see Section 3.3.4.2 of BDO's Blueprint, Control and Consolidation Under ASC 810) to be considered when determining whether the holders of the equity at risk collectively lack power. Correctly discerning between participating and protective rights is important because protective rights do not affect whether the holders of the equity at risk lack power. To hold a participating right, a PPME (or other party) must have the right to approve or veto decisions regarding the activities that most significantly impact the legal entity's economic performance (see Section 3.2.2.1.1). Protective rights, on the other hand, do not provide the holder rights to participate in decision-making over the most significant activities.

VIE DEFINITION AND INTERPRETIVE GUIDANCE



Protective rights

Protective rights are rights that do **not** give the holder rights to participate in decision-making for the activities that most significantly impact a physician practice's economic performance. Protective rights may apply only in exceptional circumstances and may include rights to:

- Approve or veto fundamental changes in the activities of a legal entity, such as:
  - Amending the physician practice's governing documents
  - Selling substantially all the physician practice's assets
  - Undertaking activities that change the physician practice's credit risk
  - Removing the decision maker upon bankruptcy or breach of contract
  - Liquidating the legal entity or causing the physician practice to enter bankruptcy
- Approve or veto administrative decisions, such as selecting the auditor or accounting policies
- Approve or veto self-dealing (related party) transactions, such as:
  - Pricing on transactions between the physician equity owner and the physician practice
  - Entering contracts between the physician practice and the decision maker's related parties

Such rights are designed to protect the holder's interests and do not affect whether the holders of the equity at risk collectively lack power.

3.2.3 Obligation to Absorb Expected Losses



FASB REFERENCES

ASC 810-10-15-14(b)(2)

> *A legal entity shall be subject to consolidation under the guidance in the Variable Interest Entities Subsections if, by design, any of the following conditions exist.…*
>
> *b. As a group the holders of the equity investment at risk lack any one of the following three characteristics…*
>
> *1. 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…*
>
> *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…*



Expected losses

A legal entity is a VIE if the holders of the equity at risk **collectively** lack the obligation to absorb the legal entity's expected losses.

The holders of the equity at risk (as a group) do not have the obligation to absorb the physician practice's losses if the physician practice or other parties involved with the practice (such as the PPME) directly or indirectly protect the holders of the equity at risk from the obligation to absorb expected losses or if the holders of the equity at risk are guaranteed a return. Therefore, if the holders of the equity at risk are not exposed to expected losses on a first-dollar basis, the physician practice is a VIE. The holders of the equity at risk must lose their entire investment (suffering a total loss) before other variable interests absorb expected losses. Otherwise, the physician practice is a VIE.

Instruments or arrangements that may protect the holders of the equity at risk from collectively absorbing the physician practice's expected losses include:

- Equity that is not at risk (see Section 3.2.1)
- Arrangements that reimburse the physician practice or the holders of the equity at risk for losses such as PPME arrangements that require the PPME to fund losses (see Section 3.1.1.3)
- Some guarantees, such as a guarantee of the physician practice's debt that does not require the equity holders to lose their entire investment before the lender can pursue the guarantor (see Section 3.1.4).

BDO INSIGHT 3-9: ARRANGEMENTS THAT ABSORB EXPECTED LOSSES

Fee arrangements with PPMEs that provide management services are often structured in a manner that exposes the PPME to risk of loss. For example, the PPME may agree (explicitly or implicitly) to provide all funding for the physician practice (which is an obligation to fund the physician practice's losses) in return for the right to receive all (or substantially all) the practice's income (after expenses). Such fee arrangements with the PPME absorb the physician practice's expected losses, so the practice is a VIE.

Similarly, if a PPME guarantees the practice's debt and the guarantee does not require the equity holders to lose their entire investment before the lender can pursue its remedies against the PPME, the guarantee absorbs the physician practice's expected losses, and the practice would be a VIE.

3.2.4 Right to Receive Expected Residual Returns



FASB REFERENCES

ASC 810-10-15-14(b)(3)

> *A legal entity shall be subject to consolidation under the guidance in the Variable Interest Entities Subsections if, by design, any of the following conditions exist....*
>
> *b. As a group the holders of the equity investment at risk lack any one of the following three characteristics…*
>
> *2. The right to receive the expected residual returns of the legal entity. The investors do not have that right if their return is capped by the legal entity's governing documents or arrangements with other variable interest holders or the legal entity. For this purpose, the return to equity investors is not considered to be capped by the existence of outstanding stock options, convertible debt, or similar interests because if the options in those instruments are exercised, the holders will become additional equity investors.*
>
> *If interests other than the equity investment at risk provide the holders of that investment with these characteristics or if interests other than the equity investment at risk prevent the equity holders from having these characteristics, the entity is a VIE…*



Expected residual returns

A legal entity is a VIE if the holders of the equity at risk **collectively** lack the right to receive the legal entity's expected residual returns.

The holders of the equity at risk collectively lack the right to receive the physician practice's expected residual returns if their return is capped by the practice's governing documents or arrangements with other variable interest holders (such as the PPME). "Capped" means the holders of the equity at risk do not have the right to receive or participate in the physician practice's expected residual returns above a threshold.

BDO INSIGHT 3-10: DECISION-MAKER FEES THAT CAP RESIDUAL RETURNS FOR EQUITY AT RISK

Decision-maker fees that receive all the physician practice's expected residual returns above a fixed percentage would cap the returns to holders of equity at risk and would cause the physician practice to be a VIE. For example, in some management service arrangements, the physician practice may be required to distribute all its income (after expenses) to the PPME. Such arrangements cap the returns to the holders of equity at risk and would cause the physician practice to be a VIE.

Because a reporting entity evaluates this characteristic of a VIE for the holders of equity at risk **collectively**, disproportionately sharing expected residual returns among the holders of the equity at risk does not cause the physician practice to be a VIE. The holders of the equity at risk can also **share** expected residual returns with other parties that do not hold equity at risk (such as with the PPME or a nominee shareholder whose equity was funded by the PPME) as long as the returns the holders of the equity at risk are entitled to receive are not capped (see Example 3-34 and Example 3-35 of BDO's Blueprint, Control and Consolidation Under ASC 810). Therefore, this evaluation differs from the determination of whether the holders of the equity at risk lack the obligation to absorb the physician practice's expected losses (see Section 3.2.3).

Reaching a conclusion about whether the holders of the equity at risk collectively lack the right to receive the physician practice's expected residual returns requires the application of professional judgment based on the facts and circumstances. It also requires understanding the risks the physician practice was designed to create and pass along to its interest holders.



FOCUS ON WHETHER THE RETURNS TO THE HOLDERS OF THE EQUITY AT RISK ARE CAPPED

If an instrument other than equity at risk prevents the holders of the equity at risk from collectively having the right to receive the physician practice's expected residual returns, and that instrument is held by a party with equity at risk, the physician practice is still a VIE. The evaluation focuses on whether the returns to the holders of the equity at risk are capped by instruments other than equity at risk, not on the identity of the party whose returns are capped.

3.2.5 Equity Holders Have Nonsubstantive Voting Rights (Anti-abuse Test)

FASB REFERENCES

ASC 810-10-15-14(c)

> *A legal entity shall be subject to consolidation under the guidance in the Variable Interest Entities Subsections if, by design, any of the following conditions exist....*
>
> *c. The equity investors as a group also are considered to lack the characteristic in (b)(1) if both of the following conditions are present:*
>
> *1. The voting rights of some investors are not proportional to their obligations to absorb the expected losses of the legal entity, their rights to receive the expected residual returns of the legal entity, or both.*
>
> *2. Substantially all of the legal entity's activities (for example, providing financing or buying assets) either involve or are conducted on behalf of an investor that has disproportionately few voting rights. This provision is necessary to prevent a primary beneficiary from avoiding consolidation of a VIE by organizing the legal entity with nonsubstantive voting interests. Activities that involve or are conducted on behalf of the related parties of an investor with disproportionately few voting rights shall be treated as if they involve or are conducted on behalf of that investor. The term related parties in this paragraph refers to all parties identified in paragraph 810-10-25-43, except for de facto agents under paragraph 810-10-25-43(d)....*
>
> *For purposes of applying this requirement, reporting entities shall consider each party's obligations to absorb expected losses and rights to receive expected residual returns related to all of that party's interests in the legal entity and not only to its equity investment at risk.*

Voting rights are nonsubstantive (anti-abuse test)

A legal entity is a VIE if the voting rights are nonsubstantive because **both** criteria are met:

- The voting rights of some investors are not proportional to their economic exposure to the legal entity.
- Substantially all the legal entity's activities involve or are conducted on behalf of an investor with disproportionately fewer voting rights, including that investor's related parties and specific de facto agents.

This characteristic of a VIE is often referred to as the "anti-abuse test." To determine whether a legal entity is a VIE under the anti-abuse test, a reporting entity follows two steps.

STEP 1

Identify disproportionality between the voting rights and economics of any investor (without including related parties and de facto agents).

STEP 2

Assess whether substantially all the legal entity's activities involve or are conducted on behalf of an investor with disproportionately fewer voting rights (including its related parties and specific de facto agents).

The anti-abuse test is meant to identify situations in which a reporting entity may have attempted to structure a legal entity with nonsubstantive voting rights to avoid consolidation while retaining substantially all the benefits from the legal entity. Although the test is designed to prevent abuse of the consolidation model, any legal entity that fails is a VIE (even if there is a valid business reason for its structure). The reporting entity must identify the legal entity's primary beneficiary.

BDO INSIGHT 3-11: PHYSICIAN PRACTICES OFTEN MEET ANOTHER VIE CHARACTERISTIC

In most cases, a physician practice has at least one of the other VIE characteristics discussed in Section 3.2; therefore, the anti-abuse test might not need to be performed. If the physician practice does not have any other characteristics of a VIE (which may be rare in practice), see Section 3.6 of BDO's Blueprint, Control and Consolidation Under ASC 810, for more information about the anti-abuse test.

3.3 IDENTIFYING THE PRIMARY BENEFICIARY

If a physician practice is a VIE, the next step is to determine whether the PPME controls and consolidates the VIE —that is, to identify the VIE's primary beneficiary. The primary beneficiary is defined in ASC 810-10-20 as *"An entity that consolidates a variable interest entity."* A PPME is the primary beneficiary and consolidates a VIE when it has a controlling financial interest in the VIE. A PPME is the primary beneficiary of a VIE if it has power and economics.

Power	Power is the ability to direct the activities that most significantly impact the VIE's economic performance (see Section 3.3.1).
Economics	Economics is the obligation to absorb the VIE's losses or the right to receive benefits from the VIE that **could** potentially be significant to the VIE (see Section 3.3.2).

Identifying the primary beneficiary is mostly a qualitative assessment. Often, more than one party has economics, but only one party, if any, has power.

The identification of the primary beneficiary is an ongoing assessment (see Section 4.5 of BDO's Blueprint, Control and Consolidation Under ASC 810). Therefore, a PPME should develop processes and internal controls over financial reporting to monitor changes in facts and circumstances that could affect its analysis.

BDO INSIGHT 3-12: RELATED PARTY AND DE FACTO AGENT CONSIDERATIONS

If no party individually is the primary beneficiary (no party individually has power and economics), the reporting entity must determine whether a related party group (including de facto agents) collectively has the characteristics of a primary beneficiary (that is, power and economics). If the analysis does not identify the primary beneficiary because neither the PPME nor a single physician equity owner individually has both power over and economics from the physician practice, the PPME needs to identify related parties and de facto agents. It might then need to apply the related party tiebreaker or the "substantially all" tests in ASC 810, depending on the facts and circumstances (see Section 3.4).

3.3.1 Power

FASB REFERENCES

ASC 810-10-25-38 through 25-38B

To be the primary beneficiary, the PPME must have power over the VIE.

Power	Power is the ability to direct the activities that most significantly impact the VIE's economic performance.

To identify the party with power, the reporting entity must analyze the nature of the risks in the VIE and determine the VIE's purpose and the variability it is designed to create and pass along to its interest holders (see Sections 2.2.1 and 2.2.2 of BDO's Blueprint, Control and Consolidation Under ASC 810). The reporting entity must then identify the activities that most significantly impact the VIE's economic performance (see Section 3.2.2.1.1) and determine how those activities are directed. The graphic illustrates these steps.



Once the reporting entity determines how decisions are made, it identifies the parties making the decisions. A party with the right to make the decisions about the activities that most significantly impact the VIE's economic performance is considered a decision maker. A reporting entity has power if it has the right to direct the activities that most significantly impact the VIE's economic performance, even if that right is triggered only if specific circumstances arise or specific events happen. A reporting entity does not have to exercise its rights to have power over a VIE.

A PARTY NEED NOT EXERCISE ITS RIGHTS TO HAVE POWER

As discussed in ASC 810-10-25-38B, *"a reporting entity does not have to exercise its power in order to have power to direct the activities of a VIE."* Accordingly, intent with respect to exercising substantive rights (or lack thereof) is **not** relevant to analyzing which party has power. Similarly, a history (or likelihood) of not exercising substantive rights is not indicative of which party has power. However, as discussed in Sections 4.2.2.1 and 4.2.2.2 of BDO's Blueprint, Control and Consolidation Under ASC 810, a reporting entity must evaluate whether others' rights to veto or block decisions are substantive. Reaching a conclusion requires the application of professional judgment based on the facts and circumstances.

A physician practice to which a PPME provides only administrative services would have only one decision maker if the physician makes all significant decisions. Alternatively, a physician practice might have multiple decision makers if some significant decisions are made by the physician owner and some are made by the PPME. Other physician practices might require some significant decisions to be made jointly between the PPME and physician. The extent to which a PPME may be granted decision-making authority is limited by various state laws regarding the corporate practice of medicine. At a minimum, such laws typically require that the physician(s) make all medical decisions but may allow a PPME to make other decisions.

A single decision maker that exercises its decision-making rights over all the significant activities through a variable interest (for example, through a contract that is a variable interest or holding a majority of voting rights through equity) has power unless a single party holds substantive kick-out rights or participating rights. However, when multiple parties direct different activities that significantly impact the VIE's economic performance, the party with the right to direct the activities that most significantly impact the VIE's economic performance is the single decision maker and has power.

BDO INSIGHT 3-13: DETERMINING WHICH ACTIVITIES ARE THE MOST SIGNIFICANT REQUIRES JUDGMENT

When multiple parties direct different activities that significantly impact the physician practice's economic performance (as in Example 3-4), the party with the right to direct the activities that most significantly impact the physician practice's economic performance is the single decision maker and has power. As such, the reporting entity must determine which activities most significantly impact the practice's economic performance.

If a PPME has the right to direct all significant activities other than providing patient care, we believe it would typically be appropriate to conclude that those activities are more significant to the economic performance of the physician practice than providing patient care. However, all facts and circumstances must be considered. There could be circumstances in which the decisions about patient care are more significant to the practice's economic performance than the other significant activities. Also, sometimes the physician owners also have decision making rights over significant activities other than patient care.

Determining which significant activities (or combination thereof) are the most significant requires judgment based on the facts and circumstances.

Examples 3-3 and 3-4 illustrate the primary beneficiary analysis in fact patterns in which multiple parties direct different activities.

EXAMPLE 3-3: CONSOLIDATION ANALYSIS — SINGLE DECISION MAKER, PPME DOES NOT CONTROL PHYSICIAN PRACTICE

FACTS

- A PPME executes a 10-year agreement with a physician practice that specifies the following rights and responsibilities:
  - The PPME will prepare annual operating and capital budgets that must be approved by the physician practice. The practice can change and approve budgets without the PPME's approval.
  - The PPME will assist the physician practice in evaluating and negotiating contracts with payors, providers, vendors, suppliers, and other third parties, but all contracts must be approved and executed by the physician practice. In other words, the practice can approve and execute contracts without the PPME's approval.
  - The PPME will provide specific equipment to the physician practice.
  - The PPME will neither control nor direct the licensed professionals in the performance of medical services for patients, and all clinical decisions will be made by the licensed professionals and the physician practice.
  - The PPME will provide all nonclinical administrative services.
- The fee for the agreement is customary and commensurate for a typical administrative services arrangement and does not expose the PPME to risk of loss. The PPME does not have any other variable interests in the physician practice and does not have an explicit or implicit commitment to fund future operating losses.
- The physician practice has insufficient equity at risk and is a VIE.
- The practice's PLLC operating agreement states that the physician equity owner makes the practice decisions. The physician equity owner is not a related party or de facto agent of the PPME, and no party has rights to call or redeem the equity.

CONCLUSION

The physician equity owner has power and economics, so it is the primary beneficiary. The PPME does not have a variable interest in the physician practice and therefore stops its consolidation analysis at that step. The PPME would recognize revenue for its contract under ASC 606.

ANALYSIS

- Step 1: Analyze the nature of the risks in the legal entity.
  - The physician practice is primarily exposed to operating risks from providing medical services.
- Step 2: Determine the legal entity's purpose and the variability it is designed to create and pass along to its interest holders.
  - The physician practice's purpose and design is to generate returns from the provision of medical services and pass along the risks and economics to the physician equity owners.
- Step 3: Identify the significant activities of the physician practice.
  - Approving operating and capital expenditure budgets
  - Executing payor contracts
  - Executing provider contracts
  - Making decisions about providing patient care.
- Step 4: Determine how decisions are made about those activities.
  - Step 4a: Is there a single decision maker? Yes. The physician equity owner is the single decision maker because the physician has the sole decision-making rights over all the significant activities identified in Step 3. Although the PPME assists the physician equity owner with some of these responsibilities (including advising the physician during contract negotiations) and provides administrative services to the physician practice, the PPME does not make any decisions that significantly impact the practice's economic performance. Also, the PPME's fees are customary and commensurate and do not expose the PPME to risk of

loss. Further, because the PPME does not have any other variable interests in the physician practice, the PPME's fees are not a variable interest.

- Step 4b: Does the single decision maker have power through a variable interest? Yes. The physician equity owner's decision-making rights come through equity ownership interests in the PLLC that absorb the variability of the physician practice.
- Step 4c: Does a single party (including its related parties and de facto agents) hold substantive kick-out rights exercisable without cause? No. Neither the PPME nor another party can call or redeem the physician owner's equity interest.
- Step 4d: Does a single party (including its related parties and de facto agents) hold substantive participating rights over all activities that most significantly impact the VIE's economic performance? No. Therefore, the physician equity owner has power.

- Economics (see Section 3.3.2).
  - The physician equity owner, through its equity interests, has the obligation to absorb losses and the right to receive the residual returns from the VIE that could potentially be significant to the VIE, so the physician equity owner has economics.
- Does any party, on a direct basis, have power and economics?
  - Yes. The physician equity owner has power and economics, so she is the primary beneficiary.

EXAMPLE 3-4: CONSOLIDATION ANALYSIS — PARTIES DIRECT DIFFERENT SIGNIFICANT ACTIVITIES, PPME CONTROLS PHYSICIAN PRACTICE

FACTS

- A PPME executes a 10-year management services agreement with a physician practice that specifies the following rights and responsibilities:
  - The PPME has the right to establish the annual operating and capital budgets without approval by the physician practice.
  - The PPME has authority to negotiate and execute contracts with payors, providers, vendors, suppliers, and other third parties without practice approval.
  - The PPME will provide specified equipment to the physician practice.
  - The PPME will neither control nor direct the licensed professionals in the performance of medical services for patients, and all clinical decisions shall be made by the licensed professionals and the physician practice.
  - The PPME will provide all nonclinical administrative services.
- The fee for the management services agreement is designed to transfer most of the practice's income (after expenses) to the PPME. Also, the PPME has an obligation to fund the physician practice's losses. Neither party has the right to terminate the PPME contract.
- The physician practice has insufficient equity at risk and is a VIE.
- The practice's PLLC operating agreement states that the decisions for the physician practice are made by its physician equity owner. The physician equity owner is not a related party or de facto agent of the PPME and no party has rights to call or redeem the equity.

CONCLUSION

Because the parties direct different activities that significantly impact the VIE's economic performance, the PPME must determine which activity or combination of activities **most** significantly impact the VIE's economic performance. Because both parties have economics, whichever party has power over the decisions that **most** significantly impact the economics of the physician practice is the primary beneficiary.

ANALYSIS

- Step 1: Analyze the nature of the risks in the legal entity.
  - The physician practice is primarily exposed to operating risks from providing medical services.
- Step 2: Determine the legal entity's purpose and the variability it is designed to create and pass along to its interest holders.
  - The physician practice's purpose and design is to generate returns from the provision of medical services and pass along the risks and benefits to the physician equity owners and the PPME.
- Step 3: Identify the significant activities.
  - Approving operating and capital expenditure budgets
  - Executing payor contracts
  - Executing provider contracts
  - Making decisions about providing patient care
- Step 4: Determine how decisions are made about those activities.
  - Step 4a: Is there a single decision maker? Yes. Decisions about the activities that most significantly impact the VIE's economic performance do not require the unanimous consent of the PPME and physician equity owners, so they do not share power. The physician equity owner directs patient care, and the PPME directs all other significant activities. Either the physician equity owner or the PPME is the single decision maker, depending on which party has the right to direct the activities that **most** significantly impact the VIE's economic performance. The PPME must determine whether making decisions about providing patient care (directed by the physician equity owner) or the remaining significant activities (which are considered collectively because they are all directed by the PPME) most significantly impact the VIE's economic performance and then perform the rest of Step 4.
  - Step 4b: Does the single decision maker have power through a variable interest? Yes. The physician equity owner has a variable interest through the equity interest because it absorbs the residual net income after the fee is paid to the PPME. The PPME's decision-making rights come through its contractual arrangement, which is a variable interest because the PPME's management fees are not customary and commensurate (because they are designed to transfer most of the practice's net income to the PPME) and they expose the PPME to risk of loss. Therefore, regardless of which party is deemed the single-decision maker in Step 4a, it has power through a variable interest.
  - Step 4c: Does a single party (including its related parties and de facto agents) hold substantive kick-out rights exercisable without cause? No. Neither party has the right to kick out the other party.
  - Step 4d: Does a single party (including its related parties and de facto agents) hold substantive participating rights over all activities that most significantly impact the VIE's economic performance? No. Neither party has participating rights. Therefore, whichever party is deemed the single decision-maker in Step 4a has power.
- Economics (see Section 3.3.2).
  - The physician equity owner, through its equity interests, and the PPME, through its fee arrangement, both have the obligation to absorb losses and the right to receive the residual returns from the VIE that could potentially be significant to the VIE. Thus, each party has economics.
- Does any party, on a direct basis, have power and economics?
  - Yes. Because each party has economics, whichever party has power is the primary beneficiary.

3.3.1.1 Potential Voting Rights (Options and Similar Instruments) When Identifying the Party With Power

As discussed in Section 4.2.5 of BDO's Blueprint, Control and Consolidation Under ASC 810, options, forward contracts, and convertible instruments to acquire a VIE's equity may give the holder the right to make decisions about the activities that most significantly impact the VIE's economic performance after they are exercised or become effective. ASC 810 does not explicitly address how to evaluate these potential voting rights when identifying whether any party has power over a VIE.

BDO INSIGHT 3-14: EVALUATING WHETHER POTENTIAL VOTING RIGHTS CONVEY CURRENT POWER

When determining whether any party has power over a VIE, we believe a reporting entity should consider the presence of options or similar instruments (such as forwards and convertible instruments) that would give the holder the right to direct the activities that most significantly impact the VIE's economic performance upon exercise or conversion. The reporting entity should consider all facts and circumstances, including:

- The VIE's purpose and design, including why the potential voting rights were provided or obtained
- Whether the potential voting rights are exercisable currently or at a future date
- Whether the potential rights are exercisable for nominal consideration, at a fixed price, or at fair value.

We believe a right to obtain power at a future date (for example, a forward to acquire equity interests at a future date or an option that is not currently exercisable) generally does **not** currently give the holder of that right power and therefore does not currently prevent another party from having power. Therefore, if the right is not **currently** exercisable (or other substantive barriers to exercise exist), power would be evaluated using the four-step model discussed in Section 3.3.1 based on the **current** rights of each party.

However, in some cases, a potential voting right might be an in-substance kick-out right that gives the holder of that right power. For example, this might be the case when a party holds a call option that is currently exercisable and is either deep in-the-money or is exercisable for a nominal amount. This fact pattern is common in physician practices that use a nominee shareholder structure (see Section 3.3.1.2).

Reaching a conclusion about whether a potential voting right gives the holder power requires the use of professional judgment based on the facts and circumstances.

3.3.1.2 Nominee Shareholder Structure

FASB REFERENCES

ASC 810-10-20: Nominee Shareholder

> *One or more shareholders whose relationship with the physician practice management entity (which can be either the physician practice management entity itself or its controlled subsidiaries) perpetually has all of the following characteristics:*
>
> *a. Time Frame:*
>
> *1. The physician practice management entity can at all times establish or effect a change in the nominee shareholder.*
>
> *2. The physician practice management entity can cause a change in the nominee shareholder an unlimited number of times, that is, changing the nominee shareholder one or more times does not affect the physician practice management entity's ability to change the nominee shareholder again and again.*

b. Discretion:

1. The physician practice management entity has sole discretion without cause to establish or change the nominee shareholder.

2. The physician practice management entity can name anyone as a new nominee shareholder (that is, the physician practice management entity's choice of an eligible nominee is not limited).

c. Impact:

1. The physician practice management entity and the nominally owned entity incur no more than a nominal cost to cause a change in the nominee shareholder.

2. Neither the physician practice management entity nor the nominally owned entity is subject to any significant adverse impact upon a change in the nominee shareholder.

To navigate state laws and restrictions on the corporate practice of medicine, PPMEs often use a nominee shareholder structure, which is sometimes referred to as a friendly physician model. The concept of the nominee shareholder was included in ASC 810 in connection with the control-by-contract model (see Section 4). However, most entities that have nominee shareholders are VIEs because the physician practices typically do not have sufficient equity at risk (see Section 3.2.1) and because the holders of equity at risk lack power (see Section 3.2.2).

In the nominee shareholder model, the PPME appoints a licensed physician (the nominee shareholder who holds the equity of the physician practice) to be responsible for all significant decisions. This nominee shareholder may be an existing owner or employee of the PPME, the selling physician who built the practice (who may become an owner or employee of the PPME as a result of the agreements), or another physician that is otherwise unrelated to either the PPME or the selling physician.

In this structure, the nominee shareholder typically owns 100% of the equity of the physician practice. At the same time, the PPME enters one or more agreements with the physician practice and nominee shareholder that gives the PPME the right to remove and replace the nominee shareholder at any time without cause. If the PPME exercises this right, the replacement shareholder must purchase the outstanding equity interests of the nominee shareholder for a small amount (such as $1,000). Because the PPME can remove and replace the nominee shareholder without cause (assuming there are no other substantive barriers to exercise), its right is similar to a currently exercisable kick-out right. Therefore, the PPME has power to make the decisions over all significant activities of the physician practice (see Section 3.2.2.1.1). If the PPME also holds economics (see Section 3.3.2), it would be the practice's primary beneficiary.

Example 3-5 illustrates the primary beneficiary analysis in a fact pattern in which there is a nominee shareholder (as defined in U.S. GAAP).

EXAMPLE 3-5: CONSOLIDATION ANALYSIS — PPME CONTROLS THROUGH A NOMINEE SHAREHOLDER STRUCTURE

FACTS

- A PPME purchases the economic rights to a physician practice for cash and enters several agreements with the physician practice.
- The PPME and practice execute a 10-year management services agreement that specifies the following rights and responsibilities:
  - The PPME will prepare annual operating and capital budgets that must be approved by the physician practice. The practice can change and approve budgets without the PPME's approval.
  - The PPME will assist the physician practice in evaluating and negotiating contracts with payors, providers, vendors, suppliers, and other third parties, but all contracts must be approved and executed by the physician practice. In other words, the practice can approve and execute contracts without the PPME's approval.
  - The PPME will provide the practice with specified equipment.

  - The PPME will neither control nor direct the licensed professionals in the performance of medical services for patients, and all clinical decisions will be made by the licensed professionals and physician practice.
  - The PPME will provide all nonclinical administrative services.
- The PPME contemporaneously executes an agreement that allows it to remove and replace the selling physician at any time without cause, with no substantive barriers to exercising this right. If the PPME replaces the selling physician, the new nominee shareholder must buy the exiting nominee shareholder's equity for $1,000.
- The fee for the management services agreement is designed to transfer all the practice's income (after expenses) to the PPME. Also, the PPME has an obligation to fund the physician practice's losses. Neither party has the right to terminate the PPME contract.
- The physician practice has insufficient equity at risk and is a VIE.
- The PLLC operating agreement for the physician practice states that the physician equity owner makes the decisions for the practice.

CONCLUSION

The PPME has power and economics, so it is the primary beneficiary.

ANALYSIS

- Step 1: Analyze the nature of the risks in the legal entity.
  - The physician practice is primarily exposed to operating risks from providing medical services.
- Step 2: Determine the legal entity's purpose and the variability it is designed to create and pass along to its interest holders.
  - The physician practice's purpose and design is to generate returns from the provision of medical services and pass along the risks and benefits to the physician equity owners and PPME.
- Step 3: Identify the significant activities of the physician practice.
  - Approving operating and capital expenditure budgets
  - Executing payor contracts
  - Executing provider contracts
  - Making decisions about providing patient care.
- Step 4: Determine how decisions are made about those activities.
  - Step 4a: Is there a single decision maker? Yes. Nominally, the physician equity owner is the single decision maker because it has the sole decision-making rights over all the significant activities of the physician practice identified in step 3.
  - Step 4b: Does the single decision maker have power through a variable interest? Yes. The physician equity owner's decision-making rights come through its equity, which is a variable interest because it absorbs some residual net income from the physician practice.
  - Step 4c: Does a single party (including its related parties and de facto agents) hold substantive kick-out rights exercisable without cause? Yes. The PPME can remove and replace the nominee shareholder at any time without cause with no substantive barriers to exercising this right. Also, the PPME has a variable interest because its management fees are not customary and commensurate, and they expose the PPME to risk of loss (see Example 3-1). Therefore, the PPME has power.
  - Step 4d: Does a single party (including its related parties and de facto agents) hold substantive participating rights over all activities that most significantly impact the VIE's economic performance? No. Therefore, the PPME has power.

- Economics.
  - The PPME, through its management fee arrangement, has the obligation to absorb losses and the right to receive the residual returns from the VIE that could potentially be significant to the VIE, so it has economics.
  - The nominee shareholder does not have an obligation to absorb losses or the right to receive residual returns from the VIE because the decision-maker fees are designed to transfer all the economics to the PPME.
- Does any party, on a direct basis, have power and economics?
  - Yes. The PPME has power and economics, so it is the primary beneficiary.

3.3.2 Economics

FASB REFERENCES

ASC 810-10-25-38A(b)

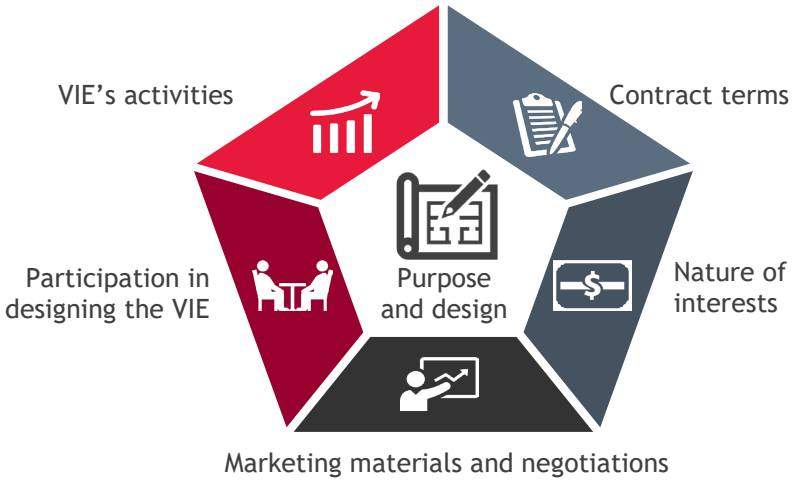
To be the primary beneficiary, the PPME must have **economics** that could potentially be significant to the VIE. Unlike power, which can be held by only one party, more than one party often has economics.

Economics

Economics is the obligation to absorb the VIE's losses or right to receive benefits from the VIE that **could** potentially be significant to the VIE.

Determining whether a party has economics is both qualitative and quantitative. When assessing whether a party has economics, factors to consider include:

- The VIE's purpose and design, including the risks it was designed to create and pass along to its interest holders (consistent with the identification of variable interests; see Section 3.1)
- The variable interest's terms and characteristics and the nature of the variability absorbed (consistent with the identification of variable interests; see Section 3.1)
- The reasons for holding the financial interest
- The magnitude of the **variability** absorbed



When assessing whether a party's economics are significant to the VIE, ASC 810 does not provide any bright lines. However, practice has generally considered economics of at least 10% to be significant. Economics of less than 10% generally is not considered significant (unless qualitative factors suggest otherwise).

However, **the 10% threshold is not a bright line**. The reporting entity must evaluate qualitative and quantitative factors, including the significance to the VIE of the variability absorbed by each variable interest and the priority in which variability is absorbed. In this evaluation, a reporting entity considers the variability in the cash flows that might be absorbed by each variable interest, which might differ from the U.S. GAAP net income that is allocated to each variable interest.

BDO INSIGHT 3-15: FEES THAT ARE NOT CUSTOMARY AND COMMENSURATE OR THAT EXPOSE THE PPME TO RISK OF LOSS TYPICALLY SATISFY THE ECONOMICS CRITERION

A PPME that has a variable interest in a physician practice because its fees are not customary and commensurate, or because the fees expose the PPME to risk of loss (see Section 3.1.1), typically satisfies the economics criterion. As such, the primary beneficiary assessment is primarily focused on the evaluation of the power criterion (see Section 3.3.1) when such an arrangement exists.

In a nominee shareholder structure, the PPME's decision-maker fee typically has the rights to most (or all) the residual returns of the physician practice; therefore, the PPME in that structure meets the economics criterion.

3.4 RELATED PARTY AND DE FACTO AGENT CONSIDERATIONS

If the analysis discussed in Section 3.3 does not identify the primary beneficiary because neither the PPME nor a single physician equity owner individually has both power over and economics from the physician practice, the PPME needs to identify related parties and de facto agents. It might then need to apply the related party tiebreaker or the "substantially all" tests in ASC 810, depending on the facts and circumstances. For example, a physician would be a de facto agent of a PPME if **any** of the following exist:

- The physician's equity was funded by the PPME.
- The physician is an officer, employee, or member of the PPME's governing board.
- The physician cannot sell, transfer, or encumber (pledge) its variable interests without the PPME's approval.

See Section 4.4 and Chapter 5 of BDO's Blueprint, Control and Consolidation Under ASC 810, for more information.

BDO INSIGHT 3-16: IDENTIFYING FACT PATTERNS WHEN NO PARTY INDIVIDUALLY HAS POWER AND ECONOMICS

For example, when a PLLC has more than one physician equity owner who must jointly agree on all decisions that significantly affect the physician practice's economics, the parties with variable interests would need to apply the guidance in ASC 810 to determine whether any of the parties controls and consolidates the physician practice, which would require identifying related parties and de facto agents.

3.5 PRESENTATION AND DISCLOSURES FOR VARIABLE INTEREST ENTITIES

Chapter 8 of BDO's Blueprint, Control and Consolidation Under ASC 810, provides guidance for presentation and disclosures in connection with a VIE.

3.6 RECONSIDERATION OF VIE STATUS

FASB REFERENCES

ASC 810-10-35-4

The initial determination of whether a legal entity is a VIE is reconsidered if **any** of the following occurs:

- The legal entity's governing documents or contractual arrangements change in a manner that affects the characteristics or adequacy of the equity at risk.
- The equity at risk or some part thereof is returned to equity investors and other interests become exposed to the legal entity's expected losses.
- The legal entity begins new activities or obtains more assets beyond those anticipated at the later of its inception or the latest reconsideration event, which increases its expected losses.
- The legal entity receives more equity at risk or changes its activities in a way that decreases its expected losses.
- Facts and circumstances change, causing the holders of the equity at risk to collectively lose the power through voting rights or similar rights to direct the activities that most significantly impact the legal entity's economic performance.

The table below shows common reconsideration events but is not an exhaustive list. A PPME should develop processes and internal controls over financial reporting to monitor changes in facts and circumstances relevant to its analysis.

Activities of the entity	▶ Buying or developing new services or locations or changing the business model in a way that increases expected losses (and was not expected as part of the physician practice's purpose and design at the most recent evaluation date). ▶ Selling businesses, locations, or assets, which decreases expected losses (and was not expected as part of the physician practice's purpose and design at the most recent evaluation date).
Terms of contracts	▶ Amending governing documents (for example, articles of incorporation, bylaws, partnership agreements, membership agreements, operating agreements, or voting agreements) in a manner that affects the characteristics or adequacy of the equity at risk. ▶ Changing decision-making rights, compensation, obligations, or other key terms in the agreement between the PPME and physician practice. ▶ Restructuring, refinancing, or modifying debt. ▶ Filing for or emerging from bankruptcy. ▶ Defaulting on loan covenants the physician practice cannot cure and for which there are no significant barriers preventing the lender from foreclosing. ▶ Lapsing or expiring substantive kick-out rights or participating rights.
Nature of interests	▶ Redeeming or repurchasing equity from the physician equity owner. ▶ Modifying the terms of equity instruments in a manner that changes the characteristics or adequacy of the equity at risk. ▶ Issuing guarantees or writing put or call options.

A physician practice that was not previously a VIE does not become a VIE simply because it incurs operating losses that reduce its equity at risk. That said, losses that reduce the equity at risk may increase the likelihood of a reconsideration event (for example, restructuring the management services agreement with the PPME or issuing debt). If a reconsideration event occurs, losses are considered in the context of the physician practice's purpose and design when evaluating whether it is a VIE.

Upon a reconsideration event, the reporting entity (PPME) also evaluates the sufficiency of equity at risk based on the fair value of the equity at risk at that date.

BDO INSIGHT 3-17: ONLY A SUBSTANTIVE CHANGE CAN CAUSE A RECONSIDERATION EVENT

Only a substantive transaction, change to an arrangement, or change in facts and circumstances can cause a reconsideration event. Nonsubstantive changes, such as changing a physician practice's fiscal year-end or tax representative, do not cause a reconsideration event. Reaching a conclusion about whether a reconsideration event has occurred requires the application of professional judgment based on the facts and circumstances.

3.7 ONGOING IDENTIFICATION OF THE PRIMARY BENEFICIARY

A reporting entity must continuously assess which party is the primary beneficiary. When a PPME is required to reconsider whether a physician practice is a VIE (see Section 3.6), it also reassesses whether the primary beneficiary has changed. But other changes in facts and circumstances can also change the primary beneficiary without triggering a reassessment of whether a physician practice is a VIE. The FASB did not list factors to consider for the ongoing identification of the primary beneficiary because it did not want to limit the analysis.[2]

BDO INSIGHT 3-18: ONGOING IDENTIFICATION OF THE PRIMARY BENEFICIARY

For PPMEs, events such as the following may cause a change in the primary beneficiary:

- Expiration and replacement of a management services agreement
- Amending a management services agreement
- Retirement of physicians
- Exercising removal rights
- Redeeming or repurchasing equity

[2] Statement of Financial Accounting Standards No. 167, *Amendments to FASB Interpretation No. 46(R)*, paragraph A14.

4. Applying the Voting Model, Including the Control-by-Contract Model

FASB REFERENCES

ASC 810-10-05-14 through 05-16, ASC 810-10-15-18 through 15-22, ASC 810-10-25-60 through 25-81, and ASC 810-10-55-206 through 55-209

The consolidation guidance applies to all legal entities with some exceptions. A PPME first determines whether it and the legal entity are in the scope of the consolidation guidance in ASC 810. The PPME then determines whether the reporting entity and legal entity are in the scope of the VIE model. If so, the PPME applies that model. If the legal entity is in the scope of the consolidation guidance but outside the scope of the VIE model, it is a voting interest entity. In that case, the PPME uses only the guidance in the general subsections of ASC 810 (for example, the voting model, including the *Consolidation of Entities Controlled by Contract* subsections of ASC 810) to determine whether it controls the voting interest entity.

In the voting model, a reporting entity generally has a controlling financial interest if it directly or indirectly owns more than 50% of a corporation's outstanding voting shares or more than 50% of a limited partnership's kick-out rights through voting interests. However, in the voting model, if other shareholders or limited partners have substantive participating rights, the majority shareholder (or the limited partner with more than 50% of the kick-out rights through voting interests) does not have a controlling financial interest in the legal entity (see Chapter 6 of BDO's Blueprint, Control and Consolidation Under ASC 810, for more guidance on the voting model). The voting model may apply if the PPME creates a new legal entity that is not a VIE to hold assets acquired from a physician practice or to hold the nonclinical (administrative) operations of a physician practice.

Although the control-by-contract guidance was written in the context of relationships between entities in the health care industry with respect to medicine, dentistry, veterinary science, and chiropractic medicine (physician practices) in which the PPME does not own a majority of the physician practice's voting equity, it could also apply to other similarly structured entities.

Arrangements in which a PPME does not own a majority of a physician practice's voting equity are common in the health care industry, which has laws and regulations that often preclude the PPME from owning equity in the practice. As an alternative, the PPME often:

- Buys the physician practice's net assets
- Assumes the physician practice's rights and responsibilities (other than the medical practice)
- Enters a long-term management services agreement with the physicians to manage the physician practice
- Signs employment and noncompete agreements with the physicians.

However, these arrangements can take various forms and allow varying degrees of participation in the physician practice by the PPME.

BDO INSIGHT 4-1: CONTROL BY CONTRACT IS RARE OUTSIDE THE VIE MODEL

In our experience, physician practices generally are outside the scope of the *Consolidation of Entities Controlled by Contract* guidance because if they are controlled by contract, they generally are VIEs. Accordingly, in practice, the guidance on physician practices controlled by contract rarely applies **unless** the physician practices are outside the scope of the VIE model. Reaching a conclusion that a PPME controls a physician practice using the *Consolidation of Entities Controlled by Contract* guidance requires the application of professional judgment based on the facts and circumstances.

If a physician practice is not a VIE, a PPME has a controlling financial interest in the physician practice using the *Consolidation of Entities Controlled by Contract* guidance if **all** the requirements below are met.

	REQUIREMENTS
Term	▶ The contract term (including renewal options unilaterally exercisable by the PPME) is for either the entire remaining legal life of the physician practice or at least 10 years. ▶ The contract cannot be canceled by the physician practice except for gross negligence, fraud, or other illegal acts by the PPME or the PPME's bankruptcy.
Control	The PPME has exclusive decision-making rights related to **both**: ▶ Total practice compensation of the licensed medical professionals, as well as the ability to establish and implement guidelines for their selection, hiring, and firing. ▶ The physician practice's ongoing, major, or central activities (except for dispensing medical services), including **all** the following: • Scope of services • Patient acceptance policies and procedures • Pricing of services • Negotiating and executing contracts • Establishing and approving operating and capital budgets • Debt issuance, if debt financing is an ongoing, major, or central source of financing for the physician practice.
Financial interest	The PPME must have a significant financial interest in the physician practice that meets **both** of the following criteria: ▶ It is unilaterally saleable or transferable by the PPME ▶ It gives the PPME the right to receive income (as ongoing fees and as proceeds from the sale of its interest in the physician practice), which changes based on the physician practice's performance and the change in fair value thereof.

ASC 810-10-25-60 through 25-81 and ASC 810-10-55-206 through 55-209 include guidance to help evaluate the above requirements.

DO NOT APPLY CONTROLLED-BY-CONTRACT GUIDANCE TO THE VIE MODEL

In some cases, the guidance in the *Consolidation of Entities Controlled by Contract* subsection differs from the VIE model. As such, a PPME cannot apply this guidance when evaluating physician practices using the VIE model. Rather, a PPME must determine whether it has power and economics, as discussed in Section 3.3, to determine whether it must consolidate a physician practice that is a VIE.

5. Initial Consolidation of a Physician Practice

A reporting entity (the parent) consolidates a physician practice (the subsidiary) beginning on the date it obtains control of the physician practice (not at the beginning or end of a reporting period) and does not recast prior periods.

It is important to determine whether a physician practice is a VIE because that can affect its initial measurement. The table below shows some fact patterns that may apply to the initial consolidation of a physician practice and the applicable initial measurement guidance.

FACT PATTERN	GUIDANCE
The VIE or voting interest entity is a business (as defined in ASC 805).	Apply the acquisition method in ASC 805, including recognizing goodwill (see Sections 5.1 and 5.2.1).
The VIE is not a business (as defined in ASC 805).	Apply the acquisition method in ASC 805 but recognize a gain or loss instead of goodwill (see Section 5.1).
The voting interest entity (including an entity in the control by contract model) is not a business.	Apply the asset acquisition guidance in ASC 805-50 (see Section 5.2.2).
The VIE and its primary beneficiary were under common control before the primary beneficiary's initial consolidation of the VIE.	Apply the common control guidance in ASC 810 (that is, carryover basis) and do not recognize a gain or loss (see Section 5.3).
The voting interest entity and its parent were under common control before the initial consolidation of the voting interest entity.	Apply the common control guidance in ASC 805-50 (that is, carryover basis) (see Section 5.3).

Chapter 3 of BDO's Blueprint, Business Combinations Under ASC 805, includes guidance for determining whether an entity meets the definition of a business.

BDO INSIGHT 5-1: A PHYSICIAN PRACTICE TYPICALLY MEETS THE DEFINITION OF A BUSINESS

In our experience, physician practices typically meet the definition of a business. However, a PPME may acquire assets (such as property or office or medical equipment) from the physician practice when it enters a service agreement with the practice. If the PPME does not obtain control of the physician practice, it might still be appropriate to account for the acquired assets as an asset acquisition (or the initial consolidation of a VIE that is not a business) if the PPME controls the assets separately from the physician practice.

After initial measurement, the consolidation principles in ASC 810 apply to both VIEs and voting interest entities. The subsequent measurement of the physician practice's assets, liabilities, and noncontrolling interest (NCI) generally are the same regardless of whether the subsidiary is a VIE or a voting interest entity, including retaining specialized or industry-specific accounting. However, ASC 810 includes specific guidance for eliminating intra-entity transactions between a VIE (the physician practice) and its primary beneficiary (see Section 7.3.4.2 of BDO's Blueprint, Control and Consolidation Under ASC 810).

5.1 INITIAL CONSOLIDATION OF A PHYSICIAN PRACTICE THAT IS A VIE

FASB REFERENCES

ASC 810-10-30-2 through 30-4 and ASC 805-30-30-1

The starting point for determining the initial measurement in a transaction in which a VIE and the reporting entity were **not** under common control is identifying the accounting acquirer.

In May 2025, the FASB issued ASU 2025-03, which indicates that if the acquisition of a VIE is effected primarily by exchanging equity interests, an entity must consider the factors in ASC 805-10-55-12 through 55-15 when identifying the accounting acquirer if the VIE meets the definition of a business. ASU 2025-03 is effective for acquisition transactions in fiscal years beginning after December 15, 2026, with early adoption allowed.

- Before the adoption of ASU 2025-03:
  - If the legal acquiree is a VIE, the primary beneficiary is always the accounting acquirer.
  - If the legal acquiree (or acquired set of assets) is not a VIE, an entity must consider the factors in ASC 805-10-55-10 through 55-15 when identifying the accounting acquirer.
- After the adoption of ASU 2025-03:
  - If the legal acquiree (or acquired set of assets) is a business and the acquisition is effected primarily by issuing or exchanging equity interests, an entity must consider the factors in ASC 805-10-55 12 through 55-15 when identifying the accounting acquirer.
  - If the legal acquiree (or acquired set of assets) is not a business, or if the acquisition is not effected primarily by issuing or exchanging equity interests:
    - If the legal acquiree is a VIE, the primary beneficiary is always the accounting acquirer.
    - If the legal acquiree (or acquired set of assets) is not a VIE, an entity must consider the factors in ASC 805-10-55-10 through 55-15 when identifying the accounting acquirer.

See Chapters 2 and 3 of BDO's Blueprint, **Business Combinations Under ASC 805**, for more guidance on identifying the acquirer and the definition of a business.

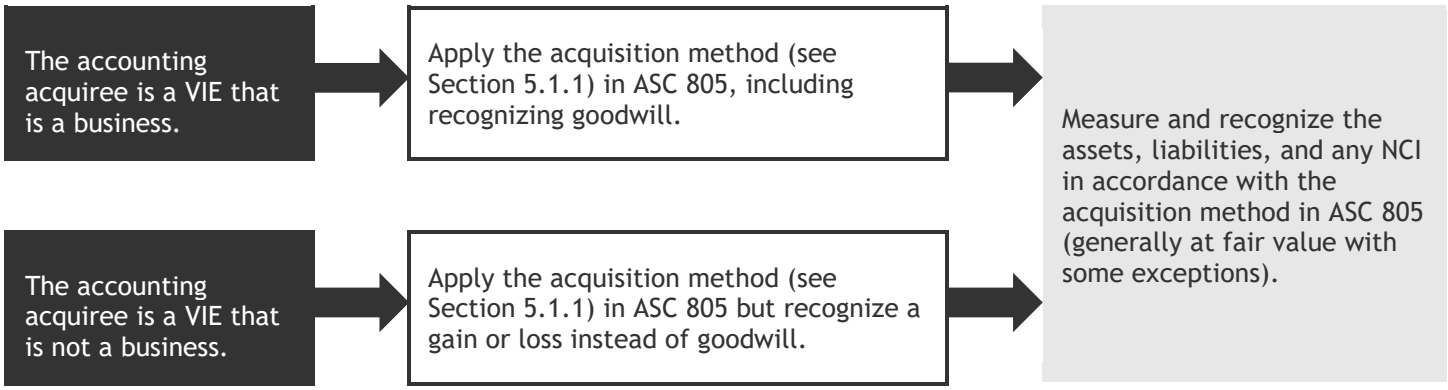
AMENDMENTS IN ASU 2025-03 CANNOT BE APPLIED BY ANALOGY IF THE VIE IS NOT A BUSINESS

The provisions of ASC 805 amended by ASU 2025-03 **only** apply when the VIE meets the definition of a business. That guidance cannot be applied by analogy (see BC35 through BC41 of ASU 2025-03). For the initial consolidation of a VIE that does not meet the definition of a business, the primary beneficiary is still always the accounting acquirer. As a result, after adopting ASU 2025-03, it is important to focus on whether the legal acquiree meets the definition of a business when the acquisition transaction is effected primarily by exchanging equity interests. If so, whether the acquiree is a VIE or not becomes less relevant when identifying the accounting acquirer.

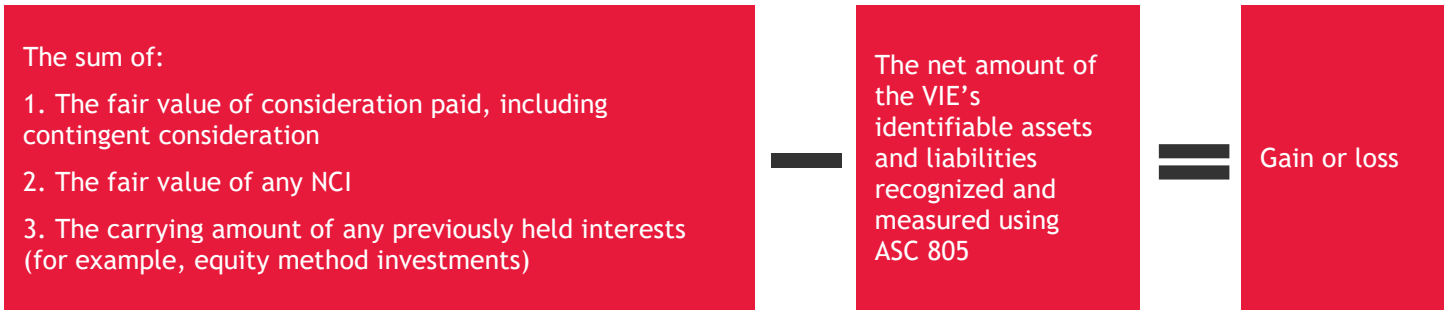
In contrast, when the legal acquiree does not meet the definition of a business, whether it is a VIE is important. The accounting for an asset acquisition of a voting interest entity differs from that of a VIE (see Appendix C of BDO's Blueprint, **Business Combinations Under ASC 805** and below).

A primary beneficiary's initial consolidation of a VIE that is not a business is outside the scope of ASC 805-50. Instead, it is accounted for in accordance with ASC 810. Under this guidance, when a reporting entity becomes the primary beneficiary of a VIE and is the accounting acquirer, and the reporting entity and VIE were **not** under common control before its initial consolidation of the VIE, the reporting entity evaluates whether the VIE meets the definition of a

business in ASC 805 (including by using the "screen" test discussed in ASC 805-10-55-5A through 55-5C; see Chapter 3 of BDO's Blueprint, Business Combinations Under ASC 805). The accounting is shown in the graphic.



As illustrated above, if the VIE does not meet the definition of a business, the primary beneficiary does not recognize goodwill. Instead, the primary beneficiary recognizes a gain or loss, which is calculated as shown in the graphic, and which must be separately disclosed.[3]



An exception from the approach above is that the primary beneficiary initially measures assets and liabilities that it transferred to the VIE at, after, or shortly before the reporting entity became the primary beneficiary at the amounts the assets and liabilities would have been measured if they were not transferred. The reporting entity does not recognize a gain or loss for such transfers, which are similar to common control transactions.

MEASUREMENT OF PREVIOUSLY HELD INTERESTS

The measurement of previously held interests in the initial consolidation of a VIE that is not a business is different from the measurement of previously held interests in a business combination.

- ASC 810-10-30-4 specifies that the primary beneficiary of a VIE that is **not** a business must recognize its previously held interest at carryover basis.
- ASC 805-30-30-1 specifies that the primary beneficiary of a VIE that is a business must recognize its previously held interests at fair value (see Section 5.5.1 of BDO's Blueprint, Business Combinations Under ASC 805).

[3] Public business entities that have adopted ASU 2024-03 must disclose such amount in the same tabular format in which the disclosures required by ASC 220-40-50-6 are provided, if the gain or loss is included entirely in one expense caption that also is a relevant expense caption. See BDO's **Bulletin** for more guidance.

5.1.1 Recognizing the Assets Acquired, Liabilities Assumed, and Noncontrolling Interests in a Business Combination

If the physician practice meets the definition of a business, the acquirer (the PPME) must recognize and measure the identifiable assets acquired, the liabilities assumed, and any NCI in the acquiree at fair value (with limited exceptions), as well as goodwill or a bargain purchase gain. The PPME must also determine the appropriate classification of the assets acquired and liabilities assumed and the accounting policies to apply. In some cases, the accounting for a business combination may be incomplete at the end of the interim or annual financial reporting period in which the combination occurs. Business combination guidance allows the PPME to recognize provisional amounts for which the accounting is incomplete for up to one year after the acquisition date (the measurement period).

If the acquired set of assets and liabilities does not meet the definition of a business, the PPME must apply other U.S. GAAP to the transaction (see Sections 5.1 and 5.2.2).

Chapter 4 of BDO's Blueprint, Business Combinations Under ASC 805, provides guidance for the initial recognition of assets acquired, liabilities assumed, and NCI. The principles outlined in that Blueprint (including the guidance for recognizing intangible assets) apply to the initial consolidation of a physician practice that is a business. There are important considerations for physician practices when determining whether intangible assets are identifiable. For example, some noncontractual rights acquired in a business combination cannot be recognized separately from goodwill because of legal transfer restrictions (see Section 5.1.1.1.2).

5.1.1.1 Intangible Assets

FASB REFERENCES

ASC 805-20-25-10 and ASC 805-10-20: Identifiable, Intangible Assets

Intangible assets are assets (not including financial assets) that lack physical substance. The term "intangible assets" refers to intangible assets other than goodwill. Identifiable intangible assets are recognized at fair value in a business combination, unless they qualify for a measurement exception (for example, reacquired rights or an asset held for sale). Section 5.5 of BDO's Blueprint, Impairments Under ASC 350 and ASC 360, discusses an accounting alternative for intangible assets available for private companies and not-for-profit entities.

An intangible asset is identifiable if it satisfies **either** criterion below.

Contractual-legal criterion	Separability criterion
It arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations (see Section 4.4.2.7.1 of BDO's Blueprint, Business Combinations Under ASC 805).	It is separable, that is, capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset, or liability, regardless of whether the entity intends to do so (see Section 4.4.2.7.2 of BDO's Blueprint, Business Combinations Under ASC 805).

Some intangible assets that meet the contractual-legal criterion also meet the separability criterion, but only one criterion must be met for an intangible asset to be identifiable. As such, an intangible asset that meets the separability criterion is identifiable even if it does not meet the contractual-legal criterion.

5.1.1.1.1 Contractual-Legal Criterion

FASB REFERENCES

ASC 805-20-55-2

Section 5.5 of BDO's Blueprint, Impairments Under ASC 350 and ASC 360, discusses an accounting alternative for intangible assets available for private companies and not-for-profit entities. If a physician practice does not elect the accounting alternative, it must recognize intangible assets that meet the contractual-legal criterion. Contractual or legal rights originate from contracts, statutes, or similar means and give the holder the right to future economic benefits. An intangible asset that arises from contractual or legal rights must be recognized separately from goodwill, even if the acquirer is contractually prohibited from transferring the asset to another party. Although transfer restrictions do not affect the recognition of an intangible asset that meets the contractual-legal criterion, they may affect the fair value.

BDO INSIGHT 5-2: INTANGIBLE ASSETS THAT MAY MEET THE CONTRACTUAL-LEGAL CRITERION

In our experience, physician practices may have a variety of intangible assets that meet the contractual-legal criterion, such as:

- Payor contracts
- Tradenames
- Noncompete agreements
- Certificates of need

This list is not comprehensive. The acquirer in a business combination must identify the acquired intangible assets individually for each acquisition because no two acquisitions are the same. Determining which intangible assets must be recognized under the contractual-legal criterion requires professional judgment based on the facts and circumstances.

5.1.1.1.2 Separability Criterion

FASB REFERENCES

ASC 805-20-55-3 through 55-5

Section 5.5 of BDO's Blueprint, Impairments Under ASC 350 and ASC 360, discusses an accounting alternative for intangible assets available for private companies and not-for-profit entities. If a physician practice does not elect the accounting alternative, it must recognize intangible assets that meet the separability criterion. An intangible asset meets the separability criterion if it is capable of being separated from the acquired business and sold or exchanged, regardless of the acquirer's intent. However, unlike with the contractual-legal criterion, if the acquirer is legally or contractually prohibited from transferring the intangible asset (for example, through sale, license, rent, or exchange), it would not meet the separability criterion (although it could still meet the contractual-legal criterion). For instance, customer lists are commonly sold or licensed and thus are generally separable. However, if the terms of confidentiality or other agreements prohibit an acquirer from selling, licensing, or otherwise exchanging customer information, the separability criterion would not be met.

BDO INSIGHT 5-3: CUSTOMER LISTS IN A PHYSICIAN PRACTICE ARE TYPICALLY NOT SEPARABLE

In our experience, customer lists obtained in the acquisition of a healthcare entity typically do not meet the separability criterion because federal laws prohibit the acquiree from selling, licensing, or exchanging customer information without the customers' express written permission. As such, unless the PPME gets permission from each of its customers, it cannot recognize a customer list as an intangible asset acquired in a business combination.

Example 5-1 illustrates a fact pattern in which a customer list does not meet the separability criterion.

EXAMPLE 5-1: REGULATORY RESTRICTIONS PREVENT RECOGNITION OF CUSTOMER LIST

FACTS

- A PPME acquires a physician practice in a business combination because it concluded that it has a controlling financial interest in the practice, as discussed in Section 3.3.
- The physician practice does not have contractual relationships with the patients.
- The physician practice keeps a database with each patient's information, including name, address, telephone number, insurer and policy number, and physicians' names.
- Patient information is legally protected and may not be sold, transferred, licensed, or exchanged without the patient's consent, which the physician practice has **not** obtained.

CONCLUSION

PPME does not recognize a separate intangible asset for the acquiree's customer list.

ANALYSIS

The physician practice's customer list does not meet the contractual-legal criterion. Further, the customer list does not meet the separability criterion because privacy laws prevent selling, transferring, licensing, or exchanging patient information separately from the acquired physician practice without the patient's consent, which the physician practice had not obtained.

5.1.1.1.3 Intangible Assets That Are Not Identifiable

FASB REFERENCES

ASC 805-20-55-6 through 55-7

An intangible asset that does not meet either the contractual-legal criterion or the separability criterion is not recognized separately; instead, its value is subsumed into goodwill. Similarly, any value attributable to other items that do not meet the definition of an asset at the acquisition date is subsumed into goodwill.

For example, if the acquiree is negotiating potential payor contracts at the acquisition date, the acquirer may attribute value to them. However, because these potential contracts are not assets at the acquisition date, the acquirer does not recognize them separately from goodwill. Further, even if the contracts are executed later, the acquirer cannot reclassify their values from goodwill after the acquisition date.

5.1.1.2 Noncontrolling Interests

FASB REFERENCES

ASC 805-20-30-7 through 30-8, ASC 805-30-30-1, and ASC 810-10-45-15 through 45-17A

ASC 810-10-20: Noncontrolling interest

> *The portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent. A noncontrolling interest is sometimes called a minority interest.*

When an acquirer obtains less than 100% of an acquiree's equity interests, it creates NCI in the acquiree. For example, if the acquirer obtains 85% of the acquiree's common stock, the remaining 15% is presented as NCI in the acquirer's consolidated financial statements.

By definition, NCI must be classified as equity in accordance with U.S. GAAP. Legal equity instruments that are classified as liabilities in accordance with U.S. GAAP are not NCI.

BDO INSIGHT 5-4: NONCONTROLLING INTERESTS CAN BE CLASSIFIED AS MEZZANINE

Although NCI is generally classified as equity in accordance with U.S. GAAP, the guidance in ASC 480-10-S99-3A on temporary equity (mezzanine) presentation applies to NCI. Therefore, if the requirements in ASC 480-10-S99-3A are met, SEC filers must present NCI outside permanent equity. See Section 5.7.1 of BDO's Blueprint, Issuer's Accounting for Complex Financial Instruments, for further information on the temporary equity guidance.

The acquirer in a business combination must recognize any NCI at its acquisition-date fair value, which often requires using valuation techniques.

BDO INSIGHT 5-5: NONCONTROLLING INTERESTS IN A PHYSICIAN PRACTICE

If a PPME determines that it controls a physician practice but does not hold equity thereof (which is often the case), all the practice's equity is NCI if classified as equity in accordance with U.S. GAAP. To determine the fair value of the NCI, the PPME must consider all the terms of the arrangements, including:

- The amounts that will be allocated between the management fee and NCI
- Any rights to repurchase the physician practice equity
- Any explicit obligations to fund the physician practice.

For example, management fee arrangements in which the PPME has the right to receive all (or substantially all) the practice's income (after expenses) may result in no (or very little) income or loss being allocated to NCI (and therefore, no (or a low) fair value for the NCI). Other fee arrangements might absorb less variability of the physician practice, resulting in more income or losses being allocated to NCI and a higher fair value.

See Section 7.3.3 of BDO's Blueprint, Control and Consolidation Under ASC 810, for guidance on accounting for NCI after the acquisition date.

5.1.2 Determining the Consideration Transferred

FASB REFERENCES

ASC 805-30-30-7 through 30-8

Most business combinations in which a PPME gains control of a physician practice involve the transfer of consideration from the PPME to the seller. Therefore, identifying the consideration transferred is a critical step for accounting for most business combinations. Such consideration includes the sum of the following at the acquisition date:



The consideration transferred in a business combination is measured at fair value with two exceptions:

- Share-based payment awards included in consideration transferred are measured in accordance with ASC 718, *Compensation — Stock Compensation* (see Section 6.4.3.2 of BDO's Blueprint, **Business Combinations Under ASC 805**).
- Transferred assets or liabilities that remain with the combined entity (the acquirer retains control of them) are measured at their carrying amounts immediately before the acquisition date (see Section 5.4.2.1 of BDO's Blueprint, **Business Combinations Under ASC 805**).

ASC 805-30 provides the following examples of potential forms of consideration for a business combination:

- Cash
- Other assets
- A business or subsidiary of the acquirer
- Contingent consideration
- Common or preferred equity instruments
- Options
- Warrants

5.1.2.1 Allocating Consideration to Transactions Accounted for Separate From the Business Combination

Not all amounts transferred by the acquirer to the seller are consideration for a business combination. In some cases, the PPME and selling physician may enter transactions that must be accounted for separate from the business combination. For example, a PPME may enter an agreement that compensates the selling physician for future services or that settles a preexisting relationship. As such, ASC 805 requires the acquirer to identify any amounts that are not part of the exchange for the physician practice and recognize them separate from the business combination.

BDO INSIGHT 5-6: ALLOCATING CONSIDERATION TO TRANSACTIONS SEPARATE FROM THE BUSINESS COMBINATION

ASC 805 does not provide guidance for allocating the consideration transferred between the business combination and the separate transactions. Absent specific guidance, there may be more than one reasonable approach. We believe it would be acceptable to account for the transactions that are separate from the business combination at fair value. Alternatively, a relative fair value allocation would also be acceptable.

Chapter 6 of BDO's Blueprint, Business Combinations Under ASC 805, provides guidance for identifying elements that are not part of the business combination.

BDO INSIGHT 5-7: CONTINGENT PAYMENTS TO SELLING PHYSICIANS MIGHT BE COMPENSATION ARRANGEMENTS

A PPME that enters into contingent payment arrangements with the selling physicians must analyze whether the contingent payments are accounted for as consideration for the business combination or as compensation. In many cases, such contingent payment arrangements are compensatory.

Contingent payment arrangements often require the selling physicians to provide services for a period of time after the acquisition to be entitled to the earnout payment. In accordance with ASC 805-10-55-25(a), contingent payments that are automatically forfeited if employment is terminated are not part of the consideration transferred but are instead compensation for post-combination services. The same is true for any amounts paid to the seller at closing that are subject to a clawback provision triggered by termination of employment.

When a selling physician does not automatically forfeit the contingent payment upon termination of employment, we believe the PPME should still assess whether there is an in-substance service period indicating that the physician must provide services to earn the contingent payment.

The factors below could indicate that a contingent payment arrangement contains an in-substance service period.

The acquiree's industry	The acquired business is in a very specialized industry, such that the employee is essential to the success of the acquired business. For example, the employee possesses expertise that is difficult to replace.
Earnings target	Earnings target is likely not achievable without the employee's continued employment.
Noncompete agreements	The employee has executed a legally enforceable noncompete agreement for a period that coincides with or is longer than the contingent payment period.
Size of contingent payment	The value of the contingent payment is significant compared to the upfront payment received by the selling shareholders.

The nature of the physician-patient relationship often results in an in-substance service period because patients might stop obtaining services from the physician practice if the physician leaves. However, because no single factor is determinative, all relevant factors must be considered. Determining whether a contingent payment arrangement includes an in-substance service period requires the application of professional judgment based on the facts and circumstances.

If there is not an explicit service requirement or an in-substance service period, the PPME must evaluate additional factors, as discussed in Section 6.4.2 of BDO's Blueprint, Business Combinations Under ASC 805, to determine whether the substance of the arrangement is compensation or consideration (see also Section 5.1.2.5 herein).

Examples 5-2 and 5-3 illustrate the accounting for contingent payment arrangements in a business combination.

EXAMPLE 5-2: CONTINGENT PAYMENT ARRANGEMENT IN A BUSINESS COMBINATION — PAYMENTS CONTINGENT ON CONTINUING EMPLOYMENT

FACTS

- PPME obtained control of a physician practice previously owned by an individual physician in a business combination because it concluded that it has a controlling financial interest in the physician practice, as discussed in Section 3.3.
- The acquisition agreement required PPME to make a $6 million payment at the acquisition date. If the physician practice increases its revenues by 10% in each of the two subsequent years, PPME will pay the selling physician an additional $2 million each year.
- The selling physician must continue to provide services to the physician practice during the two years following the acquisition. If the physician leaves for any reason other than death or permanent disability, she forfeits the subsequent payments, even if the revenue targets are met.

CONCLUSION

PPME recognizes the initial payment of $6 million as consideration paid for the business and accounts for the two additional payments of $2 million as post-combination compensation expense.

ANALYSIS

Because the physician must remain employed to receive the subsequent payments, they are post-combination compensation expense and not consideration paid. PPME accounts for the initial $6 million payment as consideration paid in accordance with ASC 805 and accounts for the subsequent payments as compensation expense.

EXAMPLE 5-3: CONTINGENT PAYMENT ARRANGEMENT IN A BUSINESS COMBINATION — IN-SUBSTANCE SERVICE PERIOD

FACTS

- PPME obtained control of a physician practice previously owned by an individual physician in a business combination because it concluded that it has a controlling financial interest in the physician practice, as discussed in Section 3.3.
- The acquisition agreement required PPME to make a $6 million payment at the acquisition date. If the physician practice increases its revenues by 10% in each of the two subsequent years, PPME will pay the selling physician an additional $2 million each year.
- There is no explicit requirement for the selling physician to continue to provide services to the physician practice during the two years after the acquisition to receive the contingent payments, but the selling physician has a two-year noncompete agreement.
- The physician's services are specialized, and it would be difficult to find a replacement physician. Also, the revenue target will be very difficult to achieve if the physician does not continue to work for the practice.

CONCLUSION

PPME recognizes the initial payment of $6 million as consideration paid for the business and accounts for the two additional payments of $2 million as post-combination compensation expense.

ANALYSIS

Although there is no explicit requirement for the selling physician to remain employed to earn the contingent payments, PPME concludes there is an in-substance service period because the physician's services are specialized, the revenue targets will be very difficult to achieve if the physician does not continue to work for the practice, and there is a legally enforceable noncompete agreement for a period that coincides with the contingent payment period. Therefore, PPME concludes that the $2 million contingent payments are post-combination compensation expense and not consideration paid. It accounts for the initial $6 million payment as consideration paid in accordance with ASC 805 and accounts for the subsequent payments as compensation expense.

5.1.2.2 Liabilities Incurred to Former Owners

FASB REFERENCES

ASC 805-30-30-7

As noted in Section 5.1.2, liabilities incurred by the PPME to the physician sellers are part of the consideration transferred unless they are deemed compensatory (see Section 5.1.2.1). Such liabilities must be recognized at fair value at the acquisition date. This includes any liability-classified contingent consideration (see Section 5.1.2.5).

Liabilities assumed by the PPME are not part of consideration transferred; instead, they are accounted for as assumed liabilities on the acquisition date balance sheet. However, the effect of recognizing an assumed liability is similar to recognizing a liability as part of the consideration transferred. In both cases, a liability is recognized and goodwill is increased (or a bargain purchase gain is decreased).

It is also common for a PPME to issue debt to a third party in connection with a business combination. Such debt is often used to finance the transaction. However, because the debt is not payable to the selling physicians, it is not part of the consideration transferred. Rather, the issuance of debt to a third party is a financing transaction that is accounted for separate from the business combination (see Chapter 6 of BDO's Blueprint, **Business Combinations Under ASC 805**).

For any debt instruments, the acquirer must consider all embedded features (such as conversion and redemption features) when determining fair value. It also must evaluate the debt instruments under ASC 480, *Distinguishing Liabilities From Equity*, and ASC 815-15, *Derivatives and Hedging — Embedded Derivatives*, to determine the accounting. See BDO's Blueprint, **Issuer's Accounting for Complex Financial Instruments**, for guidance for such instruments.

5.1.2.2.1 Deferred Consideration

FASB REFERENCES

ASC 805-30-30-7

In some business combinations, part of the consideration may be payable at a future date. If the future payment is not contingent upon a future event or condition (other than the passage of time, which is not deemed a contingency), it would not represent contingent consideration; rather it would represent deferred consideration. The acquirer (the PPME) must recognize deferred consideration at fair value as part of the consideration transferred at the acquisition date. Subsequently, the PPME would follow other applicable U.S. GAAP (for example, ASC 835, *Interest*) to account for the liability.

Example 5-4 illustrates the accounting for deferred consideration in a business combination.

EXAMPLE 5-4: DEFERRED CONSIDERATION IN A BUSINESS COMBINATION

FACTS

- PPME obtained control of a physician practice in a business combination for $10 million because it concluded that it has a controlling financial interest in the physician practice, as discussed in Section 3.3.
- The acquisition agreement requires PPME to make a $6 million payment at the acquisition date and two additional payments of $2 million (one after 15 months and one after 18 months). The additional payments are not contingent upon a future event or condition (other than the passage of time).

CONCLUSION

PPME recognizes the fair value of all the consideration transferred at the acquisition date, which includes the initial payment of $6 million and the fair value of the two additional payments of $2 million each.

ANALYSIS

The passage of time is not a contingency, so the two additional payments of $2 million are not contingent consideration because they are not contingent upon a future event or condition. Rather, they are deferred consideration (seller financing), which is accounted for at the acquisition-date fair value of the future payments. After the acquisition date, the PPME applies the interest method under ASC 835 to account for the deferred consideration liability.

A PPME may enter a noncontingent forward contract to issue equity to the sellers that will be settled after the acquisition date. In that case, the PPME must measure the deferred consideration arrangement at the acquisition-date fair value. The subsequent accounting depends on whether the equity-linked instrument is classified as equity or liability in accordance with ASC 480 and ASC 815-40, *Derivatives and Hedging — Contracts in an Entity's Own Equity*. BDO's Blueprint, **Issuer's Accounting for Complex Financial Instruments**, provides guidance for evaluating the accounting for equity-linked instruments.

5.1.2.4 Equity Interests Issued by the Acquirer

FASB REFERENCES

ASC 805-30-30-7

In general, if the acquirer (the PPME) issues its own equity to the sellers as consideration for the business combination, those equity interests must be recognized at their acquisition-date fair values using the principles of ASC 820, *Fair Value Measurement*. However, this requirement might not apply to rollover-equity or share-based payment awards. Sections 5.4.4.3 and 6.4.3 of BDO's Blueprint, **Business Combinations Under ASC 805**, and Section 5.1.2.4.1, herein, provide guidance for the evaluation of share-based payment awards exchanged for awards held by the acquiree's grantees.

For equity instruments issued that are not in the scope of ASC 718, the acquirer must consider all embedded features (such as conversion and redemption features) in determining fair value. It also must evaluate the equity instruments under ASC 480 and ASC 815 to determine the appropriate accounting for the instruments (see BDO's Blueprint, **Issuer's Accounting for Complex Financial Instruments).**

5.1.2.4.1 Rollover Equity

FASB REFERENCES

ASC 805-30-30-7 and ASC 805-10-55-25

When a PPME obtains control of a physician practice in a business combination, it might issue its equity to the selling physicians in exchange for receiving the rights to all or part of the practice's future economics. That type of exchange is often referred to as "rollover shares" or "rollover equity."

When rollover shareholders receive equity in the PPME at the same price per share as other selling physicians, the acquirer typically includes the value of the rollover equity in the consideration transferred for the business combination.

However, if either the previously held ownership interests in the physician practice or the rollover equity in the PPME are unvested, the PPME must evaluate the rollover equity as an exchange of share-based payment awards to determine whether any amount is attributable to post-combination compensation. Similarly, if the PPME issues rollover equity with a value greater than the value received by other selling shareholders, it must recognize the excess value as compensation in its post-combination financial statements. Section 6.4.3 of BDO's Blueprint, Business Combinations Under ASC 805, provides guidance for evaluating how to account for the exchange of share-based payment awards.

Example 5-5 illustrates the treatment of rollover equity in a business combination.

EXAMPLE 5-5: ROLLOVER EQUITY IN A BUSINESS COMBINATION

FACTS

- PPME obtained control of a physician practice in a business combination for $10 million because it concluded that it has a controlling financial interest in the physician practice, as discussed in Section 3.3.
- The physician practice's shares were fully vested before the business combination and have a value of $100 per share at the acquisition date.
- The $100 per-share purchase price was paid with a combination of cash and fully vested equity of PPME as follows:

	PHYSICIAN PRACTICE SHARES BEFORE TRANSACTION	CASH CONSIDERATION	ROLLOVER EQUITY	TOTAL
Physician A	60,000	$ 6,000,000	$ —	$ 6,000,000
Physician B	30,000	1,800,000	1,200,000	3,000,000
Physician C	10,000	200,000	800,000	1,000,000
Total	100,000	$ 8,000,000	$ 2,000,000	$ 10,000,000

CONCLUSION

The total consideration transferred for the business combination is $10 million, including $8 million in cash and $2 million in rollover equity.

ANALYSIS

PPME paid the same price for each share of the physician practice, regardless of whether it was settled with cash or rollover equity. Further, the physician sellers held fully vested shares of the physician practice as of the acquisition date, and no post-combination vesting is required for the rollover shares. Therefore, the entire $2 million of rollover equity is attributed to consideration transferred.

5.1.2.5 Contingent Consideration



FASB REFERENCES

ASC 805-10-55-25(a), ASC 805-30-25-5, and ASC 805-30-30-7

ASC 805-10-20: Contingent Consideration

> *Usually an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. However, contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met.*

Contingent consideration usually involves the PPME acquirer making future payments or transferring additional equity interests to the selling physicians if a future event occurs or a specified condition is met. Such arrangements are often referred to as "earn-out" provisions. However, in some cases, contingent consideration could involve the selling physicians returning a portion of the consideration previously paid.

Contingent consideration is commonly included in business combinations to help buyers (PPMEs) and sellers (selling physicians) resolve differences in their views regarding the value of the physician practice. For example, a PPME might estimate that the practice is worth an amount less than the selling physician believes is appropriate based on differences in expectations regarding future revenue or cash flow projections for the physician practice. As such, the PPME might make an offer based on its lower projections but agree to increase the price if the selling physician's projections turn out to be accurate.

Contingent consideration often includes additional payments to be transferred if the physician practice can achieve specified results (such as, targeted revenues, earnings, or EBITDA or based on nonfinancial metrics, such as patient retention). Section 5.4.5 of BDO's Blueprint, **Business Combinations Under ASC 805**, provides guidance for accounting for contingent consideration in a business combination.

However, not all contingent amounts payable to (or receivable from) the selling physicians are accounted for as contingent consideration. As discussed in Section 5.1.2.1, each contingent payment arrangement must be evaluated to determine whether it must be accounted for as contingent consideration or as a transaction separate from the business combination. Contingent payment arrangements that are determined to be separate from the business combination must be accounted for in accordance with other U.S. GAAP (for example, ASC 710, *Compensation*, or ASC 718). Chapter 6 of BDO's Blueprint, **Business Combinations Under ASC 805**, provides guidance for identifying elements that are not part of the business combination, including evaluating whether payments to selling shareholders represent contingent consideration or compensation for services (see Section 6.4.2 of that Blueprint).

BDO INSIGHT 5-8: CONTINGENT PAYMENTS TO SELLING PHYSICIANS MIGHT BE COMPENSATION ARRANGEMENTS

A PPME that enters into contingent payment arrangements with the selling physicians must analyze whether the contingent payments are accounted for as consideration for the business combination or as compensation. In many cases, such contingent payment arrangements are compensatory.

Contingent payment arrangements often require the selling physicians to provide services for a period after the acquisition to be entitled to the earnout payment. In accordance with ASC 805-10-55-25(a), contingent payments that are automatically forfeited if employment is terminated are not part of the consideration transferred but are compensation for post-combination services. The same is true for any amounts paid to the seller at closing that are subject to a clawback provision triggered by termination of employment.

When a selling physician does not automatically forfeit the contingent payment upon termination of employment, we believe the PPME should still assess whether there is an in-substance service period indicating that the physician must provide services to earn the contingent payment (see Section 5.1.2.1). If there is not an explicit service requirement or an in-substance service period, the PPME must evaluate additional factors, as discussed in Section 6.4.2 of BDO's Blueprint, **Business Combinations Under ASC 805**, to determine whether the substance of the arrangement is compensation or consideration.

Contingent payments to the selling physicians that are not post-combination compensation are part of the consideration transferred and recognized at their acquisition-date fair values. The subsequent accounting for contingent consideration depends on whether it is classified as a liability (or asset) or as equity (see Section 5.4.5 of BDO's Blueprint, **Business Combinations Under ASC 805)**.

5.1.2.6 Measurement Period Adjustments

FASB REFERENCES

ASC 805-10-25-13 through 25-18 and ASC 805-10-30-1 through 30-3

In some cases, the accounting for a business combination may be incomplete at the end of the interim or annual financial reporting period in which the combination occurs. ASC 805 allows an acquirer (the PPME) to recognize provisional amounts for which the accounting is incomplete for up to one year after the acquisition date (the measurement period). The measurement period allows the PPME a reasonable amount of time to obtain information necessary to identify and measure the various elements needed to account for the business combination (including the identifiable assets acquired, liabilities assumed, noncontrolling interests, equity interests previously held by the acquirer, and the consideration transferred).

During the measurement period, the PPME adjusts the provisional amounts (with corresponding adjustments to increase or decrease goodwill or bargain purchase gain) to reflect new information about facts and circumstances that existed at the acquisition date. The measurement period ends when the PPME receives the information it was seeking about facts and circumstances that existed at the acquisition date or learns that the information is not obtainable. However, the measurement period cannot exceed one year from the acquisition date.

The PPME recognizes measurement period adjustments with a corresponding adjustment to goodwill in the reporting period in which it identifies the adjustments. It recognizes in current-period earnings the full effect of changes in depreciation, amortization, or other income effects (by line item) that resulted from the change to the provisional amounts, calculated as if the accounting had been completed at the acquisition date.

Conversely, if information obtained after the acquisition date reflects circumstances that did not exist at the acquisition date, the accounting for the business combination is not adjusted. Such changes are accounted for in accordance with other U.S. GAAP. Information obtained shortly after the acquisition date is more likely to reflect circumstances that existed at the acquisition date than information obtained several months later.

The measurement period guidance applies to business combinations. While we believe it can be applied by analogy in pushdown accounting, it does not apply to other transactions, including asset acquisitions or recapitalizations.

If the initial accounting for a business combination is incomplete, and the amounts recognized in the financial statements have been determined only provisionally, the acquirer must include additional disclosures in its financial statements (see Section 8.8 of BDO's Blueprint, Business Combinations Under ASC 805).

5.2 INITIAL CONSOLIDATION OF A PHYSICIAN PRACTICE THAT IS NOT A VIE

When a PPME gains control of a physician practice or another entity under the voting model, including the control-by-contract model, it accounts for the acquisition as a business combination (if the acquired set is a business) or an asset acquisition (if the acquired set is not a business). This distinction is important because there are several differences in accounting for a business combination and an asset acquisition. Chapter 3 of BDO's Blueprint, Business Combinations Under ASC 805, includes guidance for determining whether an entity meets the definition of a business, and Appendix C of that Blueprint provides a summary of differences in accounting for business combinations and asset acquisitions.

5.2.1 Accounting for a Business Combination

If the physician practice or other acquiree meets the definition of a business, the acquirer (the PPME) must apply the acquisition method (see Section 5.1.1). This requires the acquirer to recognize and measure the identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree at fair value (with limited exceptions), as well as goodwill or a bargain purchase gain. The PPME must also determine the appropriate classification of the assets acquired and liabilities assumed and the accounting policies to apply. In some cases, the accounting for a business combination may be incomplete at the end of the interim or annual financial reporting period in which the combination occurs. Business combination guidance allows the PPME to recognize provisional amounts for which the accounting is incomplete for up to one year after the acquisition date (the measurement period).

If the acquired set does not meet the definition of a business, the PPME must apply other U.S. GAAP to the transaction (see Section 5.2.2).

5.2.2 Accounting for an Asset Acquisition (other than the Initial Consolidation of a VIE)

FASB REFERENCES

ASC 805-50-05-3 and ASC 805-50-15-3

The term "asset acquisition" describes the acquisition of an asset or group of assets that does not meet the definition of a business under U.S. GAAP. Some asset acquisitions also include the assumption of liabilities.

Although some asset acquisitions may be similar to business combinations, it is critical to determine whether the acquired set meets the definition of a business because the accounting for an asset acquisition that is not a VIE is fundamentally different than the accounting for a business combination.

- Business combinations are accounted for using the acquisition method (see Section 5.1.1), which generally requires measuring all elements of the transaction at fair value (with limited exceptions).
- Asset acquisitions (other than the initial consolidation of a VIE) are accounted for under a cost-accumulation model, with the cost being allocated to the acquired assets and liabilities assumed based on relative fair values (with some exceptions) (see Appendix C of BDO's Blueprint, Business Combinations Under ASC 805).

BDO INSIGHT 5-9: A PHYSICIAN PRACTICE TYPICALLY MEETS THE DEFINITION OF A BUSINESS

In our experience, a physician practice typically meets the definition of a business. However, a PPME may acquire assets (such as property, office or medical equipment) from the physician practice when it enters a service agreement with the practice. If the PPME does not obtain control of the physician practice but does control the assets separately from the physician practice, it might still be appropriate to account for the acquired assets as an asset acquisition (or the initial consolidation of a VIE that is not a business).

5.3 COMMON CONTROL TRANSACTIONS

FASB REFERENCES

ASC 805-50-05-4 through 05-5 and ASC 810-10-30-1

If a PPME obtains control of a physician practice in a common control transaction, it initially measures the practice's assets, liabilities, and NCI at the amounts reported in the ultimate parent's financial statements (or that would be reported if the ultimate parent issued U.S. GAAP financial statements). In other words, the PPME initially measures the acquisition of an entity under common control using the ultimate parent's carryover basis, consistent with other common control transactions (see Appendix B of BDO's Blueprint, Business Combinations Under ASC 805).

BDO INSIGHT 5-10: IDENTIFYING COMMON CONTROL RELATIONSHIPS

In complex organizational structures, it might be necessary to understand the nature of the relationship between upper-tier entities directly or indirectly involved with a PPME, including whether they are under common control. For example, in asset management, private equity, and similar industries, it often is necessary to assess whether investors, general partners, managing members, or similar roles are under common control to determine whether a lower-tier entity participates in a common control transaction.

It can be challenging to determine whether common control exists for entities with which management has no direct involvement and may require professional judgment based on the facts and circumstances. A reporting entity cannot assume the entities are under common control just because two legal entities have the same general partner or managing member or are managed by the same (group of) advisors or funds.

In our experience, a PPME's initial acquisition of a physician practice is generally not a common control transaction. However, determining whether common control exists requires judgment based on the facts and circumstances.

FASB PROJECT: DEFINITION OF COMMON CONTROL

In January 2026, the FASB added a project to its agenda to define "common control." Readers should monitor the FASB website for information.

5.4 DISCLOSURES FOR BUSINESS COMBINATIONS

ASC 805 provides disclosure objectives and specific disclosure requirements to help users of the financial statements understand the effects of a business combination. Disclosures are required for material business combinations, as well as for immaterial business combinations that in the aggregate are material to the financial statements.

Chapter 8 of BDO's Blueprint, Business Combinations Under ASC 805, provides guidance for disclosures in connection with a business combination.

Appendix A: Other BDO Publications



BDO's Professional Practice — Accounting Group has issued the following Blueprints, which provide detailed accounting guidance, interpretive insights, and practical examples on complex areas of U.S. GAAP:

- Accounting for Software Costs
- Statement of Cash Flows Under ASC 230
- Segment Reporting Under ASC 280
- Equity Method Investments Under ASC 323
- Impairments under ASC 350 and ASC 360
- Revenue Recognition Under ASC 606
- Share-based Payments Under ASC 718
- Business Combinations Under ASC 805
- Control and Consolidation Under ASC 810
- Accounting for Leases Under ASC 842
- Issuer's Accounting for Complex Financial Instruments

BDO's Professional Practice — SEC Services Group has issued the following Blueprints to help SEC registrants apply the SEC's rules and regulations related to financial reporting:

- Guide to Going Public

Series Overview: Building Knowledge

In addition to Blueprints, BDO's Professional Practice has issued a suite of publications related to U.S. GAAP and SEC rules and regulations:

- Bulletins: short, timely communications delivering essential news, alerts, and developments in accounting and SEC reporting
- Snapshots: summaries of SEC rules and regulations
- SEC Reporting Insights, updated annually
- Conference Highlights: Current SEC & PCAOB Developments, updated annually
- Effective Date Reminders, updated annually
- Industry Supplements
- Other publications on new accounting standards and SEC rules and regulations.

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For more information on IFRS, visit BDO's IFRS and Corporate Reporting.

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