FASB Emerging Issues Task Force

Issue No. 04-5

Title: Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights

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Previously Distributed EITF Materials: Issue Summary No. 1, dated June 10, 2004; Issue Summary No. 1, Supplement No. 1, dated September 14, 2004; Issue Summary No. 1, Supplement No. 2, dated November 4, 2004; Issue Summary No. 1, Supplement No. 3, dated March 4, 2005

References

FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements* (FAS 3)

FASB Statement No. 5, *Accounting for Contingencies* (FAS 5)

FASB Statement No. 57, *Related Party Disclosures* (FAS 57)

FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries* (FAS 94)

FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities* (FIN 46R)

Proposed FSP No. SOP 78-9-a, "Interaction of AICPA Statement of Position 78-9, *Accounting for Investments in Real Estate Ventures,* and EITF Issue No. 04-5, 'Investor's Accounting for

* **The alternative views presented in this Issue Summary Supplement are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination and it is ratified by the Board.**

an Investment in a Limited Partnership When the Investor Is the Sole General Partner and the Limited Partners Have Certain Rights'" (FSP SOP 78-9-a)

APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock* (APB 18)

APB Opinion No. 20, *Accounting Changes* (APB 20)

APB Opinion No. 29, *Accounting for Nonmonetary Transaction* (APB 29)

AICPA Accounting Research Bulletin No. 51, *Consolidated Financial Statements* (ARB 51)

AICPA Statement of Position 78-9, *Accounting for Investments in Real Estate Ventures* (SOP 78-9)

Background

1. At the March 17, 2005 EITF meeting, the Task Force considered comment letters on the draft abstract reflecting the tentative conclusions reached at the November 17–18, 2004 EITF meeting. Based on the consideration of the comment letters and further discussion, the Task Force reached a tentative conclusion on a revised framework for addressing when the general partners in a limited partnership control the limited partnership. The revised framework is included in the draft abstract in Appendix 04-5A.

2. At the March EITF meeting the Task Force also asked the FASB staff to consider changes to Issue 96-16 that would conform the guidance in that Issue about whether minority shareholder rights to veto acquisitions and dispositions of assets greater than 20 percent of the investee's total assets are substantive participating rights, to the guidance in this Issue. The Task Force directed the FASB staff to seek input from constituents on the impact of the proposed change to Issue 96-16 on current and prior practice. Accordingly, draft language proposing a change to Issue 96-16 was posted to the FASB website for a 30-day comment period that ended May 6, 2005.

3. At the June 15–16, 2005 EITF meeting, the Task Force will be asked to reconsider certain comments on Issue 04-5 in conjunction with being asked to reach a final consensus on this Issue. Specifically, the Task Force will be asked to reconsider points raised in the following areas: (a) characteristics of substantive kick-out rights, (b) inclusion of a 20 percent reference in Example 1 to Exhibit 04-5A (of the draft abstract), (c) potential disclosure requirements, and (d) a potential transition alternative for super-majority kick-out rights. Additionally, the Task Force will be asked to approve an amendment to Issue 96-16 that was proposed and posted to the website, including the consideration of transition alternatives associated with that amendment.

Re-deliberation of Issue 04-5

4. The FASB staff would like to discuss four final points regarding Issue 04-5. A brief description of these points and the FASB staff's analysis and commentary follow.

Substantive Kick-out Rights

5. Regarding the assessment of whether kick-out rights held by the limited partners are substantive, one of the required characteristics included in paragraph 7(a) of the draft abstract is that the "kick-out" rights can be exercised by a vote of a simple majority (or a lower percentage) of the limited partner voting interests held by parties other than the general partners…." A suggestion was made for this characteristic to include the notion that removal of the general partners by a single limited partner would also, in all cases, be deemed a substantive kick-out right. Accordingly, it was suggested that the beginning of paragraph 7(a) of the draft abstract read as follows: "kick-out rights can be exercised by a single limited partner or a vote of a simple majority (or a lower percentage) of the limited partner voting interests held by parties other than the general partners…."

FASB Staff Analysis

6. The draft abstract posted to the website for comment included language similar to that being proposed above and the Task Force received comments questioning how the "single limited partner" aspect of this characteristic should be applied in practice. In preparing for the March EITF meeting the staff further considered that language and believed that the Task Force decisions are more clearly reflected in the wording of paragraph 7(a), including the accompanying footnote, in Appendix 04-5A. In addition, the staff believes that the assessment of whether the kick-out right is substantive should be based on the terms of the contractual rights included in the limited partnership (or similar) agreement. That is, the staff believes that an entity should not "look through" the terms of the agreement to the ownership of the limited partner interests in assessing whether the kick-out right is substantive. For example, including the suggested wording in paragraph 7(a) would permit an entity to conclude that kick-out rights are substantive if the limited partnership agreement requires a super-majority vote to remove the general partner, and a super-majority of the limited partner interests were held by one limited partner. Subsequently, if that limited partner sold a portion of its interest to a third party, so that it no longer had the ability to remove the general partner, the kick-out rights would no longer be substantive. For this reason, the FASB staff does not recommend that a change be made to paragraph 7(a).

7. Should the Task Force decide that a single limited partner's ability to remove the general partner represents a substantive kick-out right, the staff recommends that paragraph 21 of the draft abstract be revised to require a general partner to re-assess the consolidation decision upon the change in ownership of limited partner interests. The staff believes such reassessment is warranted to address those situations in which the limited partnership agreement provides a kick-out right, the terms of which are not substantive; however, the initial limited partnership interests are closely held and therefore the presumption of control by the general partner is overcome. As paragraph 21 is currently drafted, subsequent transactions that result in wide dispersion of the limited partner interests, thus rendering the kick-out right non-substantive if re-evaluated, do not trigger reconsideration and, therefore, would not impact the consolidation decision previously made by the general partner(s).

<u>Inclusion of 20 Percent Reference in Example 1 to Exhibit 04-5A</u>

8. A suggestion was made to revise Example 1 of Exhibit 04-5A to indicate that using a 20 percent threshold in applying paragraph 14(d) of the draft abstract may be appropriate in certain circumstances. Specifically, it was recommended that the following language be included in Example 1:

> Whether the right to approve the acquisition or disposition of assets is "in the ordinary course of business" should be based on an evaluation of the relevant facts and circumstances. The right to veto acquisitions and dispositions of assets exceeding 20 percent of the fair value of the limited partnership's total assets may be a protective right when the limited partnership has numerous assets and extensive operations. However, if the limited partnership has limited operations and only a few assets, such as a real estate partnership with a limited number of properties, the right to veto acquisitions or dispositions of assets exceeding the 20 percent threshold may be a substantive participating right.

FASB Staff Analysis

9. In reaching it's tentative conclusion at the March EITF meeting, the Task Force specifically removed the 20 percent bright line threshold included in the draft abstract that was exposed for comment. The staff is concerned that including the language suggested above in Example 1 to Exhibit 04-5A would effectively re-institute the 20 percent bright line threshold into the consensus on a "presumption" basis. That is, in the case of a limited partnership that has

numerous assets and extensive operations, rights held by limited partners to veto acquisitions and dispositions that are in excess of 20 percent of the fair value of the limited partnership's total assets will be presumed to be protective rights irrespective of the substance of the right. The opposite presumption would be implied by Example 1 for those limited partnerships that have limited operations and only one or just a few assets.

10. Accordingly, the staff believes that including the proposed revision in Example 1 is inconsistent with the tentative conclusion reached by the Task Force at the March EITF meeting. Therefore, the staff recommends that the Task Force approve Example 1 as presented in the draft abstract distributed with the March EITF meeting minutes and included herein as Appendix 04-5A.

11. Task Force members will be asked whether they agree with the proposed revision to Example 1 of Exhibit 04-5A in the draft abstract. It should be noted that if the Task Force decides to include the proposed language in a final consensus for Issue 04-5, similar language should be considered for inclusion in Example 1 of Issue 96-16 (see further discussion below).

Disclosure Requirements

12. At the March EITF meeting, the Task Force discussed whether disclosures should be required in connection with reaching a consensus on this Issue. In particular, the Task Force discussed whether general partners that consolidated limited partnerships should be required to disclose information about restrictions on the ability of the consolidated entity (general partner) to take certain actions, such as sales, with respect to the assets of the limited partnership(s) included in the consolidated balance sheet. The Task Force observed that it believes that disclosure requirements currently exist that would require such disclosures related to material restrictions on assets and, therefore, concluded that such disclosures should not be required by a final consensus. Further, the Task Force noted that similar disclosure requirements are not required by Issue 96-16.

13. After the March EITF meeting, a question was raised as to whether such disclosure requirements currently exist within U.S. GAAP. Based on the FASB staff's research, with the

exception of restricted cash and restricted net assets in less than 50 percent owned investments accounted for by the equity method, the only apparent requirement to disclose restrictions on assets in a consolidated balance sheet is the requirement to disclose assets subject to lien in accordance with Regulation S-X, Section 210.4-08 (S-X 4-08). S-X 4-08 states that the following shall be set forth on the face of the appropriate statement or in appropriately captioned notes: "Assets mortgaged, pledged, or otherwise subject to lien, and the approximate amounts thereof, shall be designated and the obligations collateralized briefly identified." There is no similar general requirement to disclose assets subject to lien in GAAP for non-public enterprises.

14. With respect to the consolidation of a variable interest entity (VIE), pursuant to paragraph 23 of FIN 46R, the primary beneficiary of a VIE shall disclose the following (unless the primary beneficiary also holds a majority voting interest):

a. The nature, purpose, size, and activities of the variable interest entity
b. The carrying amount and classification of consolidated assets that are collateral for the variable interest entity's obligations
c. Lack of recourse if creditors (or beneficial interest holders) of a consolidated variable interest entity have no recourse to the general credit of the primary beneficiary.

15. The disclosure requirement imposed by paragraph 23(b) of FIN 46R is similar to the requirement considered by the Task Force at the March EITF meeting. Requiring disclosure(s) similar to those required by FIN 46R in a final consensus on Issue 04-5 creates a different reporting requirement for the consolidation of enterprises under Issue 04-5 than currently exists for the consolidation of non-VIE enterprises that are not subject to Issue 04-5. The staff believes that creating differential disclosure requirements based on the legal form of the entity is inconsistent with the EITF's objective of developing a consistent model for addressing consolidation decisions for entities that are not VIE's. If the Task Force concludes that disclosure requirements are necessary in Issue 04-5, the staff believes that the same requirements would be relevant in other situations in which assets in a consolidated balance sheet may be subject to certain restrictions or the approval of minority shareholders. Further, the staff observes that enterprises would not be prohibited from disclosing restrictions on assets, or any

other pertinent information, for entities consolidated under the provisions of Issue 04-5. Accordingly, the FASB staff recommends that the Task Force re-affirm its tentative conclusion and not require disclosures in a final consensus on Issue 04-5.

16. Task Force members will be asked whether they agree with the staff's recommendation or whether they want to include disclosure requirements in a final consensus on Issue 04-5. If the Task Force agrees to provide disclosure requirements, the staff suggests the following for inclusion in the final consensus:

> Disclosure
> A general partner that consolidates a limited partnership or limited partnerships shall disclose the carrying amount and classification of assets that are collateral for the limited partnership(s) obligations or are restricted in any way in their use by the consolidated entity.

Transition Alternative—Super-Majority Kick-Out Rights

17. A question was raised by a Task Force member to consider grandfathering kick-out rights that require a vote in excess of a simple-majority if the kick-out rights meet the remaining required characteristics of paragraph 7 for substantive kick-out rights. That is, except for the fact that a contractual kick-out right requires a vote in excess of a simple majority (for example, 66 2/3 percent of limited partners required to vote in favor of removal of the general partner), the kick-out right would be evaluated as a substantive kick-out right that would overcome the presumption of control by the general partners upon the adoption of Issue 04-5. If other changes are required to be made to the contractual kick-out rights in order for the rights to meet the requirements of paragraph 7, this alternative transition method would not be applicable. This alternative offers a practical compromise to reduce the cost and effort of amending partnership agreements for those situations in which the rights were previously structured to provide for removal of the general partner (that is, the requirements of paragraph 7(b) of the draft abstract are met), but the right was structured to require a super-majority vote because that was previously accepted in practice as a substantive right.

FASB Staff Analysis

18. Consistent with previously issued consolidation guidance, grandfathering of past practices (that is, non-consolidation when newly issued guidance would require consolidation) is typically provided in those instances in which it is not practical to obtain the information necessary to facilitate including the "controlled" entity in the consolidated financial statements of the controlling entity. In reaching its tentative conclusions, the Task Force acknowledged the practical issues associated with consolidating limited partnerships and specifically considered that enterprises may want to modify limited partnership agreements in light of this new guidance. Accordingly, the Task Force provided a delayed effective date for this Issue to allow entities to consider the impact of the new guidance on their financial statements and to make necessary changes to outstanding limited partnership agreements if they so choose.

19. The staff acknowledges the practical issues being addressed by the proposed transition alternative above. However, based on the comment letters received, it appears as though a large majority of the kick-out rights that exist today require a vote in excess of a simple majority to remove the general partner and, therefore, may likely qualify for the transition exception proposed above. Assuming the comment letters received are representative of the limited partnership population, providing the transition exception proposed may negate the transition alternatives provided (that is, retrospective application or cumulative effect), effectively resulting in prospective transition for the Issue. For the reasons outlined herein, the staff recommends that the Task Force re-affirm its tentative conclusions with respect to transition as reflected in the draft abstract included as Appendix 04-5A.

Proposed Changes to Issue 96-16

20. In response to the proposed changes to Issue 96-16 posted to the website for comment, the Task Force received one comment letter from The Accounting Principles and Auditing Standards Committee of the Florida Institute of CPA's (FICPA). FICPA's comment letter states that

> The Committee agrees with the concept that acquisitions and dispositions of assets that are not in the ordinary course of business are protective and would not overcome the presumption of consolidation by the investor with the majority interest. However, the Committee is concerned that moving from a concrete

> standard (20%) to a more flexible concept may lead to comparability problems. The Committee suggests that the Board provide additional guidance regarding ordinary course of business and perhaps include examples to assist in the application of this Issue.

FASB Staff Analysis

21. To address this comment, and to facilitate final approval of the proposed amendment by the Task Force, it is important that the rationale for including the 20 percent threshold in Issue 96-16 be understood. Comments received by one Task Force member regarding their research on the history of the original decision made in Issue 96-16 suggest that the Task Force's decision to use the 20 percent threshold in Issue 96-16 was intended as a specific "bright-line" cut-off for determining rights that were likely protective. That is, the Task Force acknowledged that defining "ordinary-course of business" was difficult and, therefore, believed that including a specific quantitative threshold in the assessment of acquisition and disposition rights had merit. The Task Force concluded that including a quantitative threshold in the final consensus would provide a "safe harbor" in which more veto rights would be deemed protective; therefore making it more difficult to overcome the presumption of control by the majority shareholder.

22. Further, the same Task Force member noted that the research conducted by the Issue 96-16 Working Group indicated that state laws generally provide that the shareholders as a group must approve acquisitions and/or dispositions of "substantially all" of the assets of a corporation. The Working Group found that the definition of "substantially all" varies by state and is generally not specifically defined; however, practice often considers 60 percent to 70 percent as "significant" and, therefore, veto rights at this level typically are presumed to be protective in nature. Given that, the Task Force decided to use a lower threshold to require consolidation in more instances in which the sole right granted to minority shareholders was the right to veto certain asset acquisitions and/or dispositions. Accordingly, the Task Force settled on including a 20 percent threshold in the final consensus.

23. As highlighted in the FICPA comment letter, elimination of the 20 percent threshold may result in differing consolidation conclusions in situations in which the minority shareholders hold

identical veto rights from a contractual standpoint. However, the tentative conclusions reached by the Task Force reflect the principle that veto rights should be evaluated based on the individual facts and circumstances, which requires an understanding of the impact that such veto rights have on an enterprise's normal or customary business activities. Assessing whether the veto rights result in the minority shareholder participating in decisions made in the ordinary course of business of the enterprise requires judgment in light of the specific facts and circumstances. Therefore, in response to FICPA's comment, while the proposed change may lead to non-comparability issues, this is a consequence of instituting a principles based assessment that requires the application of judgment.

24. Based on experience from the original deliberations of Issue 96-16, short of providing a "bright-line" safe-harbor, it would be very difficult for the Task Force to provide additional guidance, either definitional or through examples, to be used in applying the judgment required for assessing whether a transaction is undertaken in the ordinary course of business. For the reasons outlined herein, the FASB staff recommends that the Task Force re-affirm its tentative conclusion to amend the Issue 96-16 consensus as proposed.

Transition

25. As proposed, the amendment could have a significant effect on consolidation decisions reached under the guidance in Issue 96-16, both for those decisions previously made and for those decisions to be made in prospective transactions. Accordingly, the Task Force should consider transition alternatives if a consensus is reached to proceed with the amendment as proposed. Two transition alternatives are presented below for consideration.

View A: The amendment to Issue 96-16 is effective upon ratification by the Board (June 29, 2005) for new investment agreements and for investment agreements that are modified after that date.

26. Proponents of View A believe that consolidation decisions made previously in accordance with the guidance in Issue 96-16 should not be changed as a result of conforming the guidance in that Issue with the tentative conclusions reached in Issue 04-5. Accordingly, these proponents

believe that applying the guidance in the amendment on a prospective basis is the most appropriate transition for a change of this nature.

View B: The amendment to Issue 96-16 is subject to similar transition provisions (except for the effective dates) provided for in the original consensus on Issue 96-16 and those transition provisions are consistent with the transition provisions provided for in the tentative conclusions for Issue 04-5.

27. Under this transition alternative, the guidance in the amendment will be effective for all new investment agreements and for existing investment agreements that are modified after [the date of Board ratification – June 29, 2005]. For all other investment agreements, the guidance in the amendment will be effective no later than the beginning of the first reporting period in fiscal years beginning after December 15, 2005, and application of either Transition Method A or Transition Method B, described below, would be acceptable.

Transition Method A

28. For existing investment agreements that have not been modified, the guidance in the amendment should be applied in financial statements issued for the first reporting period in fiscal years beginning after December 15, 2005. Earlier application is encouraged. Thus, for a public company with a fiscal year ending on December 31, the guidance must be adopted no later than the first quarter of 2006 based on agreements in effect at the time of adoption. For a Company with a fiscal year ending on December 31 that does not issue interim financial statements, the amendment must be applied in the annual statements as of the beginning of the year ended December 31, 2006. If earlier application is chosen and the guidance is applied during an interim period other than the first interim period of the year of change, an entity shall apply the guidance in FAS 3.

29. The effect of initially applying the amendment for existing investment agreements should be accounted for similar to a change in accounting principle in accordance with paragraph 19(a)–(c) of APB 20. Thus, financial statements for prior years should be presented as previously reported and the cumulative effect, if any, of adopting the guidance on the amount of retained earnings at

the beginning of the period in which this guidance is first applied should be included in the net income of the period of the change. The effect on the opening balance sheet of adopting the amendment should be disclosed in the year of adoption. Disclosure of the pro forma effects of application on net income is not required.

30. Generally, changes in accounting for a majority ownership interest from consolidation to the equity method of accounting or changes from the equity method to consolidation would not result in an adjustment to previously reported equity or net income. However, a change from consolidation to the equity method could result in a cumulative effect adjustment if losses recognized in consolidation would not have been recognized under the equity method or vice versa (see paragraph 15 of ARB 51 and paragraph 19(i) of APB 18). Other items that would have been accounted for differently in prior financial statements if this guidance had been applied *should not be adjusted*.[1]

Transition Method B

31. Alternatively, for existing investment agreements that have not been modified, the amendment may be applied retroactively by restating the financial statements of prior periods in accordance with the provisions of APB 20. If an entity applies the amendment retrospectively, it should apply it to all investment agreements based on the facts and circumstances at the time each investment was made and it should consider changes made in later periods. Other items that would have been accounted for differently in prior financial statements if this amendment had been applied *should be adjusted* (see footnote 1 for examples) in the financial statements under Transition Method B. Under Transition Method B, retrospective application is not required for investment agreements that are no longer in effect or for which minority shareholders or minority shareholders' rights no longer exist as of the date that the amendment is adopted.

[1] For example, an exchange of securities accounted for based on recorded amounts, under the presumption that control had not been obtained (pursuant to paragraph 21 of Opinion 29, and Issue No. 01-2, "Interpretations of APB Opinion No. 29"), would not be adjusted to reflect the original exchange as a business combination even if application of the guidance in this Issue suggests that one party had obtained control. In addition, previously recorded intercompany profit elimination entries would not be revised to reflect the impact had an investment been consolidated rather than accounted for under the equity method or vice versa.

Proposed FSP SOP 78-9-a

32. If the Task Force reaches a consensus on Issue 04-5 at the June 15–16, 2005 EITF meeting, the staff plans to then discuss proposed FSP SOP 78-9-a with the Board at its June 29, 2005 meeting in conjunction with the ratification of the consensus on Issue 04-5. At that meeting, the staff will present a revised FSP that will reflect the final consensus reached on Issue 04-5 for approval by the Board. Further, any specific comments received from constituents that relate only to the FSP (as opposed to issue 04-5 and its impact on the FSP) will be discussed and considered in drafting the final FSP for approval by the Board.

Appendix 04-5A

EITF Abstracts (DRAFT[1])

Issue No. 04-5

Title: Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights

Dates Discussed: June 30–July 1, 2004; September 29–30, 2004; November 17–18, 2004; March 17, 2005; June 15–16, 2005

References: FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*

FASB Statement No. 5, *Accounting for Contingencies*

FASB Statement No. 57, *Related Party Disclosures*

FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*

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Proposed FSP No. SOP 78-9-a, "Interaction of AICPA Statement of Position 78-9, *Accounting for Investments in Real Estate Ventures,* and EITF Issue No. 04-5, 'Investor's Accounting for an Investment in a Limited Partnership When the Investor Is the Sole General Partner and the Limited Partners Have Certain Rights'"

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APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*

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ISSUE

1. For many years, financial statement preparers and auditors have debated how to evaluate whether a partnership is controlled by one of its partners. Recent guidance provided in

[1] **This draft abstract was prepared to facilitate discussion of the guidance on which the Task Force reached its tentative conclusions. It contains all substantive aspects of the tentative conclusions.**

Interpretation 46(R)[2] regarding "kick-out" rights in the context of evaluating variable interests and consolidation of variable interest entities has renewed the debate over what considerations are relevant in determining whether the general partners control a limited partnership. In practice today, the question of whether a partnership is controlled by one of its partners is typically addressed by analogizing to the guidance in SOP 78-9, which specifically provides guidance on the accounting for investments in real estate ventures, including investments in corporate joint ventures, general partnerships, limited partnerships, and undivided interests. Very little authoritative guidance exists for purposes of assessing whether a limited partner's rights are *important rights* that, under SOP 78-9, might preclude a general partner from controlling a limited partnership. As a result, differing views in practice about what rights constitute important rights have evolved over time.

2. The issue is when a general partner, or the general partners as a group, controls a limited partnership or similar entity when the limited partners have certain rights.

Scope

3. The scope of this Issue is limited to limited partnerships[3] or similar entities (such as limited liability companies that have governing provisions that are the functional equivalent of a limited partnership) that are not variable interest entities under Interpretation 46(R). This Issue does not apply to a general partner that, in accordance with generally accepted accounting principles, carries its investment in the limited partnership at fair value with changes in fair value reported in a statement of operations or financial performance. That is, if an enterprise is required to apply the consolidation guidance included in ARB 51 and Statement 94 to its investment in a limited partnership, it is within the scope of this Issue. This Issue also is not intended to change current guidance in Issue No. 00-1, "Investor Balance Sheet and Income Statement Display under the Equity Method for Investments in Certain Partnerships and Other Ventures," on when it is appropriate for a general partner to use the pro rata method of consolidation for its investment in a limited partnership.

[2] Refer to paragraph B20 of Interpretation 46(R).
[3] When used throughout this Issue, the term *limited partnerships* shall mean either a limited partnership or a similar entity.

4. The Task Force acknowledged that when a limited partnership has multiple general partners, the determination of which, if any, general partner within the group controls and, therefore, should consolidate the limited partnership is based on an analysis of the relevant facts and circumstances.[4] If no single general partner in a group of general partners controls the limited partnership, the guidance in this Issue need not be applied. The Task Force agreed that guidance on determining which general partner in a group of general partners should consolidate is beyond the scope of this Issue. However, a Task Force member observed that the concepts in this Issue may be helpful in determining whether a single general partner in a group of general partners controls a limited partnership, particularly in relation to assessing whether the combined rights of the other general partners and the limited partners taken together overcome a conclusion that a single general partner controls a limited partnership.

EITF DISCUSSION

5. The Task Force reached a consensus that the *general partners*[5] in a limited partnership should determine whether they control a limited partnership based on the application of the framework in paragraphs 6–21.

Presumption of Control

6. The general partners in a limited partnership are presumed to control that limited partnership regardless of the extent of the general partners' ownership interest in the limited partnership.[6] The assessment of whether the rights of the limited partners[7] should overcome the presumption of control by the general partners is a matter of judgment that depends on facts and circumstances. If the limited partners have either (a) the substantive ability to dissolve (liquidate) the limited partnership or otherwise remove the general partners without cause or (b)

[4] In situations involving multiple general partners, entities under common control are considered to be a single general partner for purposes of applying the guidance in this Issue.
[5] The term *general partners* refers to one or more general partners and has this meaning when used in the context of this Issue.
[6] The Task Force observed that an entity has financial statement and disclosure alternatives that may provide additional useful information. For example, an entity may highlight the effects of consolidating a limited partnership by providing consolidating financial statements or separately classifying the assets and liabilities of the limited partnership(s) on the face of the balance sheet.
[7] The term *limited partners* refers to one or more limited partners and has this meaning when used in the context of this Issue.

substantive participating rights, the general partners do not control the limited partnership. Further guidance on each of these concepts is provided below.

Do the limited partners have the substantive ability to dissolve (liquidate) the limited partnership or otherwise remove the general partners without cause?[8]

7. For purposes of this Issue, the rights underlying the limited partners' ability to dissolve (liquidate) the limited partnership or otherwise remove the general partners are collectively referred to as kick-out rights. Determination of whether the kick-out rights are substantive should be based on a consideration of all relevant facts and circumstances. Substantive kick-out rights must have both of the following characteristics:

a. The kick-out rights can be exercised by a vote of a simple majority[9] (or a lower percentage) of the limited partner voting interests held by parties other than the general partners, entities under common control with the general partners or a general partner, and other parties acting on behalf of the general partners or a general partner. The Task Force believes that all relevant facts and circumstances should be considered in assessing whether other parties,

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[8] *Without cause* means that no reason need be given for the dissolution (liquidation) of the limited partnership or removal of the general partners. *With cause* generally restricts the limited partners' ability to dissolve (liquidate) the limited partnership or remove the general partners in situations that include, but that would not be limited to, fraud, illegal acts, gross negligence, and bankruptcy of the general partners.

[9] To illustrate the application of the "simple majority" threshold, consider the following examples: (1) Assume that a limited partnership has three limited partners, none of which have any relationship to the general partners, that each holds an equal amount of the limited partner voting interests (33.33 percent). In this case, applying the simple majority requirement in the partnership agreement would require a vote of no more than two of the three limited partners to remove the general partners. Accordingly, a provision that entitles any individual limited partner to remove the general partner or a provision that requires a vote of two of the limited partners to remove the general partner would meet the requirements of paragraph 7(a) for a substantive kick-out right. However, if a vote of all three limited partners is required to remove the general partner, the right would not meet the requirements of paragraph 7(a) for a substantive kick-out right, because the required vote is greater than a simple majority. (2) Consider the same facts as in Example 1, except that there are two limited partners that each holds an equal interest. In this case, a "simple majority" would be a vote of both limited partners, so a provision entitling any individual limited partner to remove the general partner or a provision that requires a vote of both limited partners to remove the general partner would meet the requirements of paragraph 7(a) for a substantive kick-out right. (3) Consider the same facts as in Example 1, except that there are 100 limited partners that each hold an equal interest. In this case, a "simple majority" would be a vote of 51 limited partners, so a provision that requires a vote of less than 52 limited partners to remove the general partner would meet the requirements of paragraph 7(a) for a substantive kick-out right. However, if a vote of 52 or more limited partners is required to remove the general partner, that provision would not meet the requirements of paragraph 7(a) for a substantive kick-out right because the required vote is greater than a simple majority.

including, but not limited to, those defined as related parties in Statement 57, may be acting on behalf of the general partners in exercising their voting rights as limited partners.

b. The limited partners holding the kick-out rights have the ability to exercise those rights if they choose to do so; that is, there are no significant barriers to the exercise of the rights. Barriers include, but are not limited to:

   (1) Kick-out rights subject to conditions that make it unlikely they will be exercisable, for example, conditions that narrowly limit the timing of the exercise

   (2) Financial penalties or operational barriers associated with dissolving (liquidating) the limited partnership or replacing the general partners that would act as a significant disincentive for dissolution (liquidation) or removal

   (3) The absence of an adequate number of qualified replacement general partners or the lack of adequate compensation to attract a qualified replacement

   (4) The absence of an explicit, reasonable mechanism in the limited partnership agreement or in the applicable laws or regulations, by which the limited partners holding the rights can call for and conduct a vote to exercise those rights

   (5) The inability of the limited partners holding the rights to obtain the information necessary to exercise them.

8. For purposes of applying paragraph 7, the limited partners' unilateral right to withdraw from the partnership in whole or in part (withdrawal right) that does not require dissolution or liquidation of the entire limited partnership would not overcome the presumption that the general partners control the limited partnership (that is, the withdrawal right is not deemed to be a kick-out right). The requirement to dissolve or liquidate the entire limited partnership upon the withdrawal of a limited partner or partners is not required to be contractual for a withdrawal right to be considered as a potential kick-out right. That is, if a limited partnership is economically compelled to dissolve or liquidate upon the withdrawal of a limited partner, the withdrawal right is considered to be a potential kick-out right.

9. If, based on the preceding evaluation, the limited partners possess substantive kick-out rights, presumption of control by the general partners would be overcome and each of the general

partners would account for its investment in the limited partnership using the equity method of accounting.

Do the limited partners have substantive participating rights?

10. If the limited partners have substantive participating rights, the presumption of control by the general partners would be overcome and each of the general partners would account for its investment in the limited partnership using the equity method of accounting. Substantive participating rights provide the limited partners with the ability to effectively participate in significant decisions that would be expected to be made in the ordinary course of the limited partnership's business.

11. The Task Force agreed that "participating rights" are different from "protective rights." All limited partners' rights could be described as "protective rights," but some rights also allow the limited partners to participate in certain financial and operating decisions of the limited partnership that are made in the ordinary course of business (referred to as participating rights). The Task Force agreed that limited partners' rights that are only protective in nature (referred to as "protective rights") do not overcome the presumption that the general partners control the limited partnership. The Task Force agreed that limited partners' rights, individually or in the aggregate, that provide the limited partners with the right to effectively participate in significant decisions that would be expected to be made in the ordinary course of the limited partnership's business while being protective of the limited partners' investment overcome the presumption that the general partners control the limited partnership.

12. For purposes of applying this framework, decisions made in the ordinary course of business are defined as decisions about matters of a type consistent with those normally expected to be addressed in directing and carrying out the limited partnership's current business activities, regardless of whether the events or transactions that would necessitate such decisions are expected to occur in the near term. However, it must be at least reasonably possible that those events or transactions that would necessitate such decisions will occur. Ordinary course of business does not include self-dealing transactions with the general partners.

13. The Task Force reached a consensus that the following guidance should be considered in evaluating whether rights held by the limited partners overcome the presumption of control by the general partners.

Protective Rights

14. The Task Force believes that limited partners' rights (whether granted by contract or by law) that would allow the limited partners to block the following limited partnership actions would be considered protective rights and would not overcome the presumption of control by the general partners.

a. Amendments to the limited partnership agreement.
b. Pricing on transactions between the general partners and the limited partnership and related self-dealing transactions.
c. Liquidation of the limited partnership initiated by the general partners or a decision to cause the limited partnership to enter bankruptcy or other receivership.
d. Acquisitions and dispositions of assets that are not expected to be undertaken in the ordinary course of business. (Limited partners' rights relating to acquisitions and dispositions that are expected to be made in the ordinary course of the limited partnership's business are participating rights. Determining whether such rights are substantive requires judgment in light of the relevant facts and circumstances—see "Factors to Consider" and Exhibit 04-5A.)
e. Issuance or repurchase of limited partnership interests.

15. The Task Force considered the above to be illustrative of some, but not all, of the protective rights that often are provided to limited partners.

Substantive Participating Rights

16. The Task Force believes that limited partners' rights (whether granted by contract or by law) that would allow limited partners to effectively participate in the following actions of the limited partnership should be considered substantive participating rights and would overcome the presumption that the general partners control the limited partnership:

a. Selecting, terminating,[10] *and* setting the compensation of management responsible for implementing the limited partnership's policies and procedures

b. Establishing operating *and* capital decisions of the limited partnership, including budgets, in the ordinary course of business.

17. The Task Force believes that in evaluating the limited partners' rights to determine whether they are substantive, "participation" means the ability of the limited partners to approve or block actions proposed by the general partners. That is, the general partners must have the limited partners' agreement to take the actions outlined above in order for the rights to be substantive participating rights. Participation does not require the ability of the limited partners to initiate actions.

18. The Task Force considered the rights described in paragraph 16 to be illustrative of substantive participating rights, but not necessarily an all-inclusive list. The Task Force believes that the rights noted above are participating rights because, in the aggregate, the rights allow the limited partners to effectively participate in the decisions that occur as part of the ordinary course of the limited partnership's business and are significant factors in directing and carrying out the activities of the limited partnership. Individual rights, such as the right to veto the termination of management responsible for implementing the limited partnership's policies and procedures (if management is outsourced—via contract with a third party—by the general partners), should be assessed based on the facts and circumstances to determine whether they are substantive participating rights in and of themselves. However, limited partners' rights that appear to be participating rights but that by themselves are not substantive (see "Factors to Consider" and Exhibit 04-5A) would not overcome the presumption of control by the general partners in the limited partnership. The likelihood that the veto right will be exercised by the limited partners should not be considered when assessing whether a limited partner right is a substantive participating right.

[10] Rights held by the limited partners to remove the general partners from the partnership should be evaluated as kick-out rights pursuant to paragraph 7 of this Issue. Rights of the limited partners to participate in the termination of management (for example, management is outsourced to a party other than the general partner) or the individual members of management of the limited partnership may be substantive participating rights.

Factors to Consider

19. The Task Force agreed that the following factors should be considered in evaluating whether limited partners' rights that appear to be participating are substantive rights—that is, whether these factors provide for effective participation in significant decisions related to the limited partnership's ordinary course of business:

a. The limited partnership agreement needs to be considered to determine at what level decisions are made—by the general partners or by the limited partnership as a whole—and the rights at each level also should be considered. In all situations, any matters that can be put to a vote of the limited partnership must be considered to determine whether the limited partners, individually or in the aggregate, have substantive participating rights by virtue of their ability to vote on matters submitted to a vote of the limited partnership. Determination of whether matters that can be put to a vote of the limited partners, or the vote of the limited partnership as a whole, are substantive should be based on a consideration of all relevant facts and circumstances.

b. Relationships between the general partners and the limited partners (other than investment in the common limited partnership) that are of a related-party nature, as defined in Statement 57, should be considered in determining whether the participating rights of the limited partners are substantive. For example, if the limited partner in a limited partnership is a member of the immediate family of the general partners of the limited partnership, then the rights of the limited partner likely would not overcome the presumption of control by the general partners.

c. Certain limited partners' rights may deal with operating or capital decisions that are not significant to the ordinary course of business of the limited partnership. The Task Force concluded that limited partners' rights related to items that are not considered significant for directing and carrying out the activities of the limited partnership's business are not substantive participating rights and would not overcome the presumption of control by the general partners. Examples of such limited partners' rights relate to decisions about location of the limited partnership's headquarters, name of the limited partnership, selection of auditors, and selection of accounting principles for purposes of separate reporting of the limited partnership's operations.

d. Certain limited partners' rights may provide for the limited partners to participate in significant decisions that would be expected to be made in certain business activities in the "ordinary course of business"; however, the Task Force concluded that the existence of such limited partners' rights should not overcome the presumption that the general partners have control if it is remote[11] that the event or transaction that requires the limited partners' approval will occur.

e. General partners who have a contractual right to buy out the interest of the limited partners in the limited partnership for fair value or less should consider the feasibility of exercising that contractual right when determining whether the participating rights of the limited partners are substantive. If such a buyout is prudent, feasible, and substantially within the control of the general partners, the general partners' contractual right to buy out the limited partners demonstrates that the participating right of the limited partners is not a substantive right. The existence of such call options, for purposes of this Issue, negate the participating rights of the limited partners to approve or veto an action of the general partners rather than create an additional ownership interest for the general partners. It would not be "prudent, feasible, and substantially within the control of the general partners" to buy out the limited partners if, for example, (a) the limited partners control technology that is critical to the limited partnership or (b) the limited partners are the principal source of funding for the limited partnership.

20. The examples in Exhibit 04-5A are presented to illustrate how to assess individual limited partners' rights under the consensus in this Issue.

[11] *Remote* is defined in Statement 5 as "the chance of the future event or events occurring is slight."

Initial Assessment and Reassessment of Limited Partners' Rights

21. The assessment of limited partners' rights and their impact on the presumption of control of the limited partnership by the general partners should be made when an investor(s) becomes a general partner(s) and should be reassessed if (a) there is a change to the terms or in the exercisability of the rights of the limited partners or general partners, (b) the general partners increase or decrease their ownership of limited partnership interests, or (c) there is an increase or decrease in the number of outstanding limited partnership interests.

Transition

22. The Task Force reached a consensus that for general partners of all new limited partnerships formed and for existing limited partnerships for which the partnership agreements are modified, the guidance in this Issue is effective after [the date of Board ratification – June 29, 2005]. The Task Force also reached a consensus that for general partners in all other limited partnerships, the guidance in this Issue is effective no later than the beginning of the first reporting period in fiscal years beginning after December 15, 2005, and that application of either Transition Method A or Transition Method B, described below, would be acceptable.

Transition Method A

23. For existing limited partnership agreements that have not been modified, the guidance should be applied in financial statements issued for the first reporting period in fiscal years beginning after December 15, 2005. Earlier application is encouraged. Thus, for a public company with a fiscal year ending on December 31, the guidance must be applied no later than the beginning of the first quarter of 2006, based on agreements in effect at the time of adoption. For a company with a fiscal year ending on December 31 that does not issue interim financial statements, the guidance must be applied in the annual statements as of the beginning of the year ended December 31, 2006. If earlier application is chosen and the guidance is applied during an interim period other than the first interim period of the year of change, an entity should apply the guidance in Statement 3.

24. The effect of initially applying this guidance for existing limited partnership agreements should be accounted for similar to a change in accounting principle in accordance with paragraphs 19(a)–(c) of Opinion 20. Thus, financial statements for prior years should be presented as previously reported, and the cumulative effect, if any, of adopting the guidance on the amount of retained earnings at the beginning of the period in which this guidance is first applied should be included in the net income of the period of the change. The effect on the opening balance sheet of adopting the new accounting principle should be disclosed in the year of adoption. Disclosure of the pro forma effects of application on net income is not required.

25. Generally, a change in accounting for a general partner's interest in a limited partnership from the equity method of accounting to consolidation or a change from consolidation to the equity method would not result in an adjustment to previously reported equity or net income. However, a change from the equity method to consolidation could result in a cumulative effect adjustment if losses that would not have been recognized under the equity method are required to be recognized in consolidation or vice versa (see paragraph 15 of ARB 51, and paragraph 19(i) of Opinion 18). Other items that would have been accounted for differently in prior financial statements if this guidance had been applied *should not be adjusted*.[12]

Transition Method B

26. Alternatively, for existing limited partnership agreements that have not been modified, this guidance may be applied by restating the financial statements of prior periods in accordance with the provisions of Opinion 20. If an entity applies this guidance retrospectively, it should apply it to all existing limited partnership agreements based on the facts and circumstances at the time each investment was made and it should consider changes made in later periods. Other items that would have been accounted for differently in prior financial statements if this guidance had been applied *should be adjusted* in the financial statements under Transition Method B. Under Transition Method B, retrospective application is not required for investments in limited

[12] For example, an exchange of securities accounted for based on recorded amounts, under the presumption that control had not been obtained (pursuant to paragraph 21 of Opinion 29, and Issue No. 01-2, "Interpretations of APB Opinion No. 29"), would not be adjusted to reflect the original exchange as a business combination even if application of the guidance in this Issue suggests that one party had obtained control. In addition, previously recorded intercompany profit elimination entries would not be revised to reflect the impact had an investment been consolidated rather than accounted for under the equity method or vice versa.

partnerships for which the entity is no longer a general partner as of the date that the guidance in this consensus is adopted.

Board Ratification

27. At its [June 29, 2005] meeting, the Board ratified the consensus reached by the Task Force in this Issue.

STATUS

28. No further EITF discussion is planned.

Exhibit 04-5A

EXAMPLES OF HOW TO ASSESS INDIVIDUAL LIMITED PARTNERS' RIGHTS UNDER ISSUE 04-5

The Task Force agreed that the following examples would facilitate the understanding of how to assess whether the rights of the limited partners should be considered protective or participating and, if participating, whether the rights are substantive. Although these examples illustrate the possible assessments of individual limited partners' rights, the evaluation of limited partners' rights should consider all of the factors identified in "Factors to Consider" to determine whether the limited partners' rights, individually or in the aggregate, provide for the limited partners to effectively participate in significant decisions that would be expected to be made in the "ordinary course of business."

Example 1

The rights of the limited partners relating to the approval of acquisitions and dispositions of assets that are expected to be undertaken in the ordinary course of business may be substantive participating rights. Rights related only to acquisitions that are not expected to be undertaken in the ordinary course of business usually are protective and would not overcome the presumption of control by the general partners in the limited partnership. Whether the right to approve the acquisition or disposition of assets is "in the ordinary course of business" should be based on an evaluation of the relevant facts and circumstances. In addition, if approval by the limited partners is necessary to incur additional indebtedness to finance an acquisition that is not in the limited partnership's ordinary course of business, then the approval by the limited partners would be considered a protective right.

Example 2

Existing facts and circumstances should be considered in assessing whether the rights of the limited partners relating to a limited partnership incurring additional indebtedness are protective or participating rights. For example, if it is reasonably possible or probable that the limited partnership will need to incur the level of borrowing that requires limited partner approval in its ordinary course of business, the rights of the limited partners would be viewed as substantive participating rights.

Example 3

The rights of the limited partners relating to dividends or other distributions may be protective or participating and should be assessed in light of the available facts and circumstances. For example, rights to block customary or expected dividends or other distributions may be substantive participating rights, while rights to block extraordinary distributions would be protective rights.

Example 4

The rights of the limited partners relating to a limited partnership's specific action (for example, to lease property) in an existing business may be protective or participating and should be assessed in light of the available facts and circumstances. For example, if the limited partnership had the ability to purchase, rather than lease, the property without requiring the approval of the limited partners, then the rights of the limited partners to block the limited partnership from entering into a lease would not be substantive.

Example 5

The rights of the limited partners relating to a limited partnership's negotiation of collective-bargaining agreements with unions may be protective or participating and should be assessed in light of the available facts and circumstances. For example, if a limited partnership does not have a collective-bargaining agreement with a union or if the union does not represent a substantial portion of the limited partnership's work force, then the rights of the limited partners to approve or veto a new or broader collective-bargaining agreement are not substantive.

Example 6

Provisions that govern what will occur if the limited partners block the action of the general partners need to be considered to determine whether the rights of the limited partners to block have substance. For example, if (a) the limited partnership agreement provides that if the limited partners block the approval of an operating budget, then the budget simply defaults to last year's budget adjusted for inflation and (b) the limited partnership operates in a mature business for which year-to-year operating budgets would not be expected to vary significantly, then the rights of the limited partners to block the approval of the operating budget do not allow the limited partners to effectively participate and are not substantive.

Example 7

Limited partners' rights relating to the initiation or resolution of a lawsuit may be considered protective or participating depending on the available facts and circumstances. For example, if lawsuits are a part of, or are expected to be a part of, the limited partnership's ordinary course of business, as is the case for some insurance entities, then the limited partners' rights may be considered substantive participating rights.

Example 8

The limited partners have the right to veto the annual operating budget for the first X years of the limited partnership. Based on the facts and circumstances, during the first X years of the limited partnership this right may be a substantive participating right. However, following Year X there is a significant change in the exercisability of the limited partners' right (for example, the veto right terminates). As of the beginning of the period following Year X, since that right no longer exists, the presumption that the general partners control the partnership would not be overcome.