

Defining Issues[®]

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EITF Approves Four Consensuses, Including a Change in General Partners' Accounting for Limited Partnerships

The Emerging Issues Task Force reached four Consensuses at its June meeting that are subject to ratification by the FASB later this month.¹ The approved Consensuses would affect accounting by general partners evaluating whether to consolidate limited partnerships, lessees who purchase leasehold improvements or acquire them in a business combination, issuers of debt and preferred-stock instruments with conversion features that may need to be accounted for as derivatives, and employers with German Altersteilzeit early retirement programs or similar subsidized programs that pay benefits during inactive or reduced-service periods. The EITF also reached tentative conclusions on purchases and sales of inventory with the same counterparty in the same line of business.

Consolidating Limited Partnerships (EITF 04-5)

The EITF agreed on a framework for evaluating whether a general partner or a group of general partners controls a limited partnership and therefore should consolidate it. The framework would make it more difficult for a general partner to overcome the presumption that it controls the limited partnership, making it more likely that general partners would be required to consolidate limited partnerships. The new guidance is significantly different from the guidance in SOP 78-9, which would be amended to conform to this Consensus.²

The EITF agreed that the presumption of general-partner control would be overcome only when the limited partners have either of two types of rights. The first type—referred to as “kick-out rights”—is the right to dissolve or liquidate the partnership or otherwise remove the general partner “without cause.” The second type—referred to as “participating rights”—is the right to effectively participate in significant decisions made in the ordinary course of the

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¹ EITF Issue Nos. 04-5, 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; 05-6, Determining the Amortization Period for Leasehold Improvements; 05-2, The Meaning of “Conventional Convertible Debt Instrument” in EITF Issue No. 00-19, “Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock”; 05-5, Accounting for the Altersteilzeit Early Retirement Programs and Similar Type Arrangements.

² Proposed FSP 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.

partnership's business. The kick-out rights and the participating rights must be substantive in order to overcome the presumption of general-partner control.

Limited partners' kick-out rights are not substantive unless they are exercisable either by a *single* limited partner or by a vote of no more than a simple majority of the limited-partner voting interests other than those held by the general partner and entities under common control with the general partner. Kick-out rights are also not substantive if there are significant barriers to their exercise. The unilateral right of the limited partners to withdraw from the partnership is not a substantive kick-out right unless the withdrawal would cause the partnership to dissolve.

Substantive participating rights include:

- Selecting, terminating, and setting the compensation of management responsible for implementing the limited partnership's policies and procedures, and
- Establishing the limited partnership's operating and capital decisions, including budgets, in the ordinary course of business.

Unlike substantive participating rights, "protective rights" do not overcome the presumption that a general partner controls a limited partnership. The guidance for distinguishing protective from substantive participating rights is much the same as the guidance in EITF 96-16 for determining whether the presumption of control by a corporation's majority owner is overcome by the minority owner's rights.³

If the FASB ratifies the Consensus, its guidance will be effective immediately for all newly-formed limited partnerships and for existing

limited partnership agreements that are modified. The guidance will be effective for existing limited-partnership agreements that are not modified no later than the beginning of the first reporting period in fiscal years beginning after December 15, 2005.

The EITF also agreed to conform the language in EITF 96-16, which addresses the majority owner's accounting for investments in corporate entities, to the guidance in EITF 04-5. EITF 96-16's twenty-percent threshold for determining whether minority shareholders' rights to block acquisitions and dispositions of assets are substantive participating rights will be replaced with language characterizing rights to block acquisitions and dispositions of assets as substantive participating rights if they are "in the ordinary course of business." The replacement would apply prospectively for new investment agreements or investment agreements modified after the FASB ratifies the new language.

Acquired Leasehold Improvements (EITF 05-6)

The Task Force agreed that leasehold improvements acquired in a business combination should be amortized over the lesser of the useful life of the assets or a term that includes renewals at the lessee's option determined to be reasonably assured at the date of the business combination. Significant leasehold improvements acquired well after the lease commencement date would similarly be amortized over the lesser of the useful life of the assets or a term that includes renewals determined to be reasonably assured at the date the leasehold improvements are acquired.

The guidance in this Consensus would be effective for periods beginning after the date

the FASB ratifies it. Early application would be permitted in periods for which financial statements have not yet been issued. The guidance would be applied prospectively to the amortization period for newly-acquired leasehold improvements that were either acquired well after the lease commencement date or acquired in a business combination.

Two related subjects may be considered later. The first is whether the amortization periods for *existing* leasehold improvements should be reassessed when a new leasehold improvement is acquired well after the lease commencement date and will be amortized over a term beyond the original lease term. The second is whether the period to recognize straight-line rents should ever be extended beyond the original lease term in circumstances where the lessee is not permitted to reassess the lease classification.

Conventional Convertible Debt Instruments (EITF 05-2)

Issuers of convertible debt are required by Statement 133 to evaluate whether it is necessary to separate the "embedded" conversion feature from the debt contract and account for the conversion feature as if it were a separate derivative instrument.⁴ If the issuer determines that the embedded conversion feature would be classified in equity if it were a freestanding instrument, the conversion feature is not separated from the debt contract. EITF 00-19's criteria must be applied to determine whether a conversion feature qualifies for equity classification, but it exempts a conversion feature embedded in a "conventional convertible debt instrument" from some of the criteria—for example, being able to settle by delivering unregistered shares.⁵

³ EITF Issue No. 96-16, *Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholders Have Certain Approval or Veto Rights*.

⁴ FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, June 1998, par. 12, available at www.fasb.org.

⁵ EITF Issue No. 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*.

The June Consensus on EITF 05-2 has three conclusions.

- The exemption from some of the EITF 00-19 criteria for “conventional convertible debt” should be retained;
- Instruments are “conventional” if they are convertible into a fixed number of shares (or an equivalent amount of cash at the discretion of the issuer) and are exercisable based on the passage of time or a contingent event; and
- A conversion feature embedded in preferred stock with a mandatory redemption date qualifies for the exemption if it is “more akin” to debt than equity and provides the holder with an option to convert into a fixed number of shares.

Under the June Consensus, convertible instruments that may be settled in a combination of cash or shares, e.g., those referred to as “Instrument C” in EITF 90-19, and instruments that may be convertible into a variable number of shares are not “conventional.”⁶ As a result, nonconventional instruments would need to satisfy all requirements of EITF 00-19 to support a conclusion that the conversion feature does not require accounting separate from that for the debt contract.

If ratified by the FASB, the Consensus will be effective prospectively for all new instruments and modifications to existing instruments entered into after the ratification date.

ATZ Early Retirement Programs (EITF 05-5)

The German *Altersteilzeit* or ATZ early retirement program is designed to create an incentive for employees to transition into early

retirement. The program was created by legislation in 1996 and is now scheduled to expire in 2009. The German government provides a subsidy or reimbursement to an employer for certain costs if the employer meets requirements such as hiring qualifying replacement employees. Typically, an employer offers the following two ATZ arrangements:

- Type I: The participating employee works 50 percent of the time for each year of the entire ATZ period and receives 50 percent of his or her salary each year.
- Type II: The participating employee works full-time for half (the active service period) of the ATZ period, does not work for the remaining half (the inactive period), and receives 50 percent of his or her salary each year during the entire ATZ period.

Under both Types I and II, participants also receive an annual bonus if they work for the agreed-upon period of time.

The EITF reached these conclusions: The salary should be accrued during the active service period. In a Type II arrangement, the salary would be fully-accrued by the end of the first half of the ATZ period (at a discounted amount if the future period extends beyond one year) since that is the period when the employee works to earn the salary. The bonus under a Type II arrangement should be accrued over the active service period as a postemployment benefit in accordance with Statement 112.⁷ Accruals for the cost of the benefits should begin at the date the individual employees enroll in the ATZ arrangement. The company should recognize the government subsidy only when it meets the criteria necessary to receive the subsidy.

If ratified by the FASB, the Consensus will be effective for financial statements issued for fiscal years beginning after December 15, 2005. A company should recognize the effect of initially applying this Consensus as a change in accounting estimate inseparable from a change in accounting principle as described in Statement 154.⁸

Exchanges of Inventory with the Same Counterparty (EITF 04-13)

The Task Force *tentatively concluded* that purchases and sales of inventory with the same party in the same line of business should be combined and accounted for as nonmonetary exchanges in accordance with Opinion 29 if they are entered into “in contemplation” of one another.⁹ The tentative conclusion would apply to purchases and sales under one or more contracts. The inventory could be raw materials, work-in-process, or finished goods. These kinds of transactions are often found in industries such as chemicals and oil and gas.

At its March 2005 meeting, the Task Force reached a tentative conclusion that when the purchase and sale of inventory with the same party in the same line of business is accounted for as a nonmonetary exchange, the transfer of finished goods inventory in exchange for either raw materials inventory or work-in-process inventory should be recognized at fair value, if the transaction has commercial substance as described in Statement 153.¹⁰ Nonmonetary exchanges of inventory in the same line of business involving either the transfer of raw materials or work-in-process inventory or the receipt of finished-goods inventory would be accounted for at the recorded amount of the assets relinquished.

⁶ EITF Issue No. 90-19, *Convertible Bonds with Issuer Option to Settle for Cash upon Conversion*.

⁷ FASB Statement No. 112, *Employers’ Accounting for Postemployment Benefits*, November 1992, available at www.fasb.org.

⁸ FASB Statement No. 154, *Accounting Changes and Error Corrections*, May 2005, par. 21, available at www.fasb.org.

⁹ APB Opinion No. 29, *Accounting for Nonmonetary Transactions*, May 1973.

¹⁰ FASB Statement No. 153, *Exchanges of Nonmonetary Assets*, December 2004, par. 2, available at www.fasb.org.



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The Task Force also tentatively concluded that a company should use its own entity-specific criteria to classify inventory among the three categories.

The tentative conclusions will be posted to the FASB Web site for public comment and will be considered again at the EITF's September meeting.

Rent Costs Incurred During Construction (EITF 05-3)

A lessee's construction of leasehold improvements may take a significant period of time to complete. Some lessees in this situation capitalize rent costs incurred during the construction period. Other lessees expense the costs. The EITF was unable to reach a consensus on the appropriate accounting for the costs. However, the FASB may address this question in an FASB Staff Position. In the absence of any new requirement, companies may continue to apply their existing accounting policies to rent costs incurred during the leasehold-improvement construction period.

Liquidated Damages Clauses in Registration-Rights Agreements (EITF 05-4)

EITF 00-19 requires that a company be able to deliver unregistered shares and meet other criteria in order to classify a freestanding financial instrument in equity. Because of these requirements, some companies enter into registration-rights agreements in conjunction with a financing transaction where the entity may issue a combination of stock, convertible securities, and warrants. Many of these registration-rights agreements require a liquidated damages payment—typically computed as a percentage of the offering proceeds—if the company fails to register its shares within a specified period of time. The EITF did not resolve how the liquidated damages clause affects the application of the EITF 00-19 criteria and is expected to continue to discuss the issue at its next meeting.

Convertible Instrument Subject to a Call Option (EITF 05-1)

Convertible debt instruments may become convertible when a contingent event occurs, such as the company's stock price achieving a specified target. These instruments may also become convertible if they are called by the issuer. The EITF discussed accounting for conversions of these instruments upon the issuer's exercise of a call option and is expected to continue to discuss the accounting and the related earnings-per-share implications at its next meeting.



The official minutes to the June EITF meeting are expected to be posted to the FASB Web site early in July. The EITF will hold its next meeting September 14-15.

The descriptive and summary statements above are not intended to be a substitute for the text of the EITF's Consensuses, tentative conclusions, or official minutes; any forthcoming FASB Staff Position; or any of the other potential or actual requirements. Nor are any of the cited documents necessarily applicable to any entity's specific circumstances. In determining the appropriate accounting treatment for a transaction, one should refer to the texts of the applicable documents that set out requirements, including the formal EITF meeting minutes that will be made available on the FASB Web site, and consult their accounting and legal advisors.