

Defining Issues[®]



When Should General Partners Consolidate Limited Partnerships

General partners will have to reassess how they account for their investments in limited partnerships if, as expected, the EITF adopts a proposed framework for evaluating whether the general partner controls the limited partnership.¹ The proposed framework would make it harder for a general partner to overcome the presumption that it controls the limited partnership and could increase consolidations of limited partnerships by general partners under the provisions of existing partnership agreements. The EITF's tentative conclusions were reached last week and will be reconsidered at its meeting in June, at which time a final Consensus is expected to be reached.

A Consensus on Issue 04-5 would be effective immediately after it is ratified by the FASB both for newly formed limited partnerships and for limited partnerships whose partnership agreements are modified after the date of ratification. Calendar-year-end general partners in all other limited partnerships would have to apply the Consensus beginning January 1, 2006.² General partners in limited partnerships that have not been modified after the date a Consensus on Issue 04-5 is ratified would be permitted to initially apply the new guidance by a cumulative-effect adjustment or by retroactively restating prior periods.

Scope

EITF 04-5 would apply to limited partnerships with one or more general partners. The term *general partner* would refer to either the sole general partner or, if the limited partnership has more than one general partner, to the general partners as a group. If the final guidance in EITF 04-5 indicates that a group of general partners controls the limited partnership, each general

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¹ EITF Issue No. 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*, formerly entitled *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*. The draft Abstract containing the EITF's previous tentative conclusions on Issue 04-5 reached at the November 2004 meeting had been posted on the FASB Web site for public comment.

² EITF 04-5 would be effective no later than the beginning of the first reporting period in fiscal years beginning after December 15, 2005.

partner in the group would evaluate its investment to see whether it controls the limited partnership and should consolidate the limited partnership.

Tentative Conclusions

The proposed requirements would replace counterpart requirements in SOP 78-9, which nominally provides guidance on accounting for investments in real-estate ventures, but has come to be used for all types of limited partnerships.³ The tentative conclusions reached by the EITF are based on the same presumption in SOP 78-9 that the general partner controls the limited partnership and should consolidate it, regardless of the level of its ownership interest. However, EITF 04-5 would establish a new framework for evaluating whether the presumption that the general partner controls the limited partnership is overcome.

Based on the tentative conclusions, the presumption of general-partner control would be overcome only if 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 of rights—referred to as participating rights—is the right to effectively participate in significant decisions made in the ordinary course of the partnership’s business. The kick-out rights and the participating rights must be substantive in order to overcome the presumption of general-partner control.

Kick-out rights are not substantive unless they are exercisable by a vote of a simple majority of the limited partners, excluding

those limited partners that are under common control with the general partner. Kick-out rights are also not substantive if there are any significant barriers to their exercise. Barriers of this sort can include provisions that limit the timing of exercise, financial penalties or operational drawbacks from changing from one general partner to another, or the absence of qualified replacements for the general partner. The unilateral right of the limited partners to withdraw from the partnership is not a substantive kick-out right unless the withdrawal would directly or indirectly result in the dissolution or liquidation of the limited partnership.

Substantive participating rights enable the limited partners to participate in significant decisions made in the ordinary course of the limited partnership’s business. The limited partners have these rights if they can approve or block the general partner’s decisions to select, terminate, and set management’s compensation or to establish operating policies and make capital decisions in the ordinary course of business. The guidance for applying the concept of substantive participating rights is substantially the same as the EITF’s guidance used to determine whether the presumption of control by a majority owner of a corporation is overcome by minority owners’ rights.⁴

Substantive participating rights would have to be distinguished from “protective rights,” which do not overcome the presumption that the general partner controls the limited partnership. The presumption of control would not be overcome, for example, by the power of the limited partners to approve or veto an amendment to the limited-partnership agree-

ment, issuance or repurchase of limited partnership interests, liquidation of the limited partnership, pricing transactions between the general partner and the limited partnership, or acquisitions and dispositions of assets that would not be expected to be made in the ordinary course of the limited partnership’s business.

The EITF discussed whether the right by the limited partners to veto acquisitions or dispositions of assets exceeding 20 percent of the fair value of the entity’s total assets is a protective or participating right in the context of limited-partnership structures. The EITF agreed that determinations of whether rights to approve acquisitions and dispositions of assets are substantive participating rights should be based on an evaluation of the relevant facts and circumstances. Consistent with the guidance in EITF 96-16, the right to veto acquisitions or 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. To avoid inconsistencies between the guidance in the two Consensuses, the FASB staff intends to propose conforming language for EITF 96-16 that would be effective concurrent with a final Consensus on EITF 04-5. The proposed conforming language is expected to be posted to the FASB’s Web site and considered at the EITF’s June meeting.

³ AICPA Statement of Position 78-9, *Accounting for Investments in Real Estate Ventures*.

⁴ EITF Issue No. 96-16, *Investor’s Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights*.

Potential Effect on Practice

If the EITF reaches a Consensus in June that is ratified by the FASB, general partners will need to review their accounting to ensure compliance with the revised consolidation requirements. Whether this results in additional consolidations will depend, in part, on whether existing limited partnerships are modified and on how new partnerships are structured.

Current practice could be significantly changed by the proposed framework's criterion governing a substantive right to remove the general partner. The right is not considered substantive if it requires a vote of more than a simple majority of the limited-partnership interests. General partners that historically have not consolidated limited partnerships because of kick-out rights held by the limited-partners would need to revisit each partnership agreement to determine whether those rights are "substantive" under EITF 04-5. Kick-out rights that require a super-majority vote (e.g., 66 or 75 percent of the limited-partnership interests) would not be considered "substantive" and, therefore, would not overcome the presumption of general-partner control. Similarly, the unilateral right of the limited partners to withdraw from the limited partnership would not overcome the presumption of control unless the withdrawal would directly or indirectly result in the dissolution or liquidation of the partnership.

Other limited-partner rights that now overcome the presumption of general-partner control, such as rights to approve the sale, refinancing, or acquisition of principal partnership assets, would also need to be reevaluated under the

Issue 04-7 on VIEs Suspended

At its March meeting, the EITF suspended discussion of Issue 04-7 on what types of variability in an entity should be considered for purposes of applying Interpretation 46R and how an entity should determine which interests in the entity should be considered variable interests. The EITF requested that the FASB instead provide additional guidance on the application of Interpretation 46R.*

The EITF had been evaluating two approaches for identifying variable interests—the Presumption Approach and the Risk Approach. The Presumption Approach would require the consideration of either fair-value or cash-flow variability in a particular entity based on the nature of that entity's operations and would also have provided a scope exception to Interpretation 46R for specified interest-rate and foreign-currency swap contracts. The Risk Approach focuses primarily on isolating risks that are disproportionately borne by the subordinated interest holders for purposes of identifying variable interests in an entity. FASB Board members in attendance at the EITF meeting noted that Interpretation 46R's objective is to identify the entity's relevant risks and the interests that are, by design, exposed to those risks. The Board members acknowledged that either of the two approaches might assist in making that determination, but indicated that consideration of the entity's design is also necessary.

The EITF agreed to keep Issue 04-7 on its agenda until the FASB decides whether it will provide additional guidance on the application of Interpretation 46R. If the FASB decides not to provide additional guidance, the EITF may resume its deliberations on Issue 04-7.

* EITF Issue No. 04-7, Determining Whether an Interest Is a Variable Interest in a Potential Variable Interest Entity; FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities.

provisions of EITF 04-5. The general partner would have to determine that the rights are participating because they pertain to activities that would be expected to occur in the normal course of business to overcome the presumption of general-partner control.

A general partner that previously accounted for its investment in the limited partnership using the equity method, but is required when transitioning to the EITF 04-5 model

to consolidate a limited partnership, may have to recognize losses that were not recognized under the equity method. Other items that would have been accounted for differently in prior financial statements if EITF 04-5 had been applied would only be adjusted if the general partner chose to account for the effect of initially applying the Consensus by retroactive application to prior periods.



In order to conform the accounting for investments in real-estate ventures to the framework proposed in EITF 04-5, a proposed FASB Staff Position would amend SOP 78-9.⁵ The amendment would refer to the guidance in EITF 04-5, eliminating the related requirements now in SOP 78-9. The FASB is expected to issue a final FSP to effect that change when a final Consensus is reached on EITF 04-5.



Although the tentative conclusions reached by the EITF do not constitute requirements as yet, general partners should consider evaluating their partnership agreements to learn whether a final Consensus is likely to affect their accounting.

The descriptive and summary statements above are not intended to substitute for the text of the EITF's tentative conclusions for Issue 04-5, 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. Those accounting for investments in limited partnerships should refer to the texts of the applicable documents that set out requirements and consult their accounting and legal advisors.

This is a publication of KPMG's
Department of Professional
Practice—Audit and Risk Advisory
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⁵ 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, '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.'