

FASB Emerging Issues Task Force

Issue No. 04-5

Title: 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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References

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)

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

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

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)

* **The alternative views presented in this Issue Summary 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.**

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" (Issue 96-16)

EITF Issue No. 98-6, "Investor's Accounting for an Investment in a Limited Partnership When the Investor Is the Sole General Partner and the Limited Partners Have Certain Approval or Veto Rights" (Issue 98-6)

Background

1. For many years, financial statement preparers and auditors have debated how to evaluate whether a partnership should be consolidated by one of its partners. Recent guidance provided in FIN 46R¹ 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 making that evaluation, particularly with regard to whether the general partner should consolidate a limited partnership. In practice today, the question of whether a partnership should be consolidated 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.

2. Paragraph 9 of SOP 78-9 provides the following guidance regarding consolidation by general partners of limited partnerships:

The rights and obligations of the general partners in a limited partnership are different from those of the limited partners. Some believe that general partners should be deemed to have the controlling interest in a limited partnership. However, if limited partners have **important rights**, such as the right to replace the general partner or partners, approve the sale or refinancing of principal assets, or approve the acquisition of principal partnership assets, the partnership may not be under the control, directly or indirectly, of the general partnership interests. The division believes that the general partners are in control and should account for their investments in accordance with the recommendations in paragraph .07² only if the substance of the partnership or other agreements provides for control by the general partners. [Emphasis and footnote reference added.]

3. Very little authoritative guidance exists for purposes of making an assessment about whether a limited partner's rights are *important rights*. As a result, views in practice about what rights constitute important rights have evolved over time.

¹ Refer to paragraphs B18–B21 of FIN 46R.

² Paragraph 7 of SOP 78-9 states that "The division believes that a controlling investor should account for its investment under the principles of accounting applicable to investments in subsidiaries."

4. Since the issuance of SOP 78-9, other accounting guidance has been proposed or issued that has affected partnership consolidation considerations. The first was the 1995 FASB Exposure Draft, *Consolidated Financial Statements: Policy and Procedures* (the 1995 Consolidation ED), which was intended to address issues in the application of the control-based consolidation model. Subsequently, in 1996, the EITF added Issue 96-16 to its agenda to address certain consolidation issues. Issue 96-16, which addresses whether certain rights held by minority shareholders overcomes the presumption of FAS 94 that all majority-owned investees should be consolidated, but specifically excludes from its scope investments in non-corporate entities. In Issue 96-16, the Task Force reached a consensus that established the framework within which the analysis of the rights of minority shareholders should be developed:

...the minority rights, individually or in the aggregate, provide for the minority shareholder to effectively participate in significant decisions that would be expected to be made in the "ordinary course of business." Effective participation means the ability to block significant decisions proposed by the investor who has a majority voting interest. That is, control does not rest with the majority owner because the investor with the majority voting interest cannot cause the investee to take an action that is significant in the ordinary course of business if it has been vetoed by the minority shareholder.

5. Although SOP 78-9 continued to be applied to limited partnership arrangements, questions began to arise in practice as practitioners attempted to reconcile the *participating rights concept* of Issue 96-16 to the *important rights concept* of SOP 78-9.

6. In 1998, partially as a result of the difficulties in applying the guidance in Issue 96-16 by analogy to non-corporate entities, the EITF formed the Issue 98-6 Working Group to evaluate the feasibility of integrating the important rights of limited partners described in SOP 78-9 and the substantive participating rights described in Issue 96-16. Although the Task Force developed a framework to address the practice question in Issue 98-6, no consensus was reached because of a concern about whether the framework was an improvement to current practice. The Task Force ultimately removed Issue 98-6 from its agenda with the expectation that the issues would be resolved by the FASB in its 1999 Exposure Draft, *Consolidated Financial Statements: Purpose and Policy* (the 1999 Consolidation ED). The output from the Issue 98-6 working group has been used as a significant source of input to this Issue Summary.

7. The FASB issued the 1999 Consolidation ED after re-deliberating issues identified by comment letters received on the 1995 Consolidation ED (primarily involving the application of the guidance to special purpose entities and the characteristics of control), intending to provide revised guidance on consolidation policy only. The 1999 Consolidation ED concluded that in the absence of evidence that demonstrates otherwise, the sole general partner of a limited partnership should be presumed to control the partnership if no other partner or organized group of partners has the current ability to dissolve the limited partnership or otherwise remove the general partner. However, the 1999 Consolidation ED was never issued as a final FASB Statement. In 2001, the FASB refocused its efforts on the types of entities perceived as being most in need of more robust consolidation literature. The effort culminated in the issuance of FIN 46, which was replaced by FIN 46R, in December 2003. FIN 46R introduced an economic risks and rewards consolidation model to be applied to entities for which the voting interest consolidation model is not effective in identifying a controlling financial interest, such as those that are not controlled through voting interests or those in which the equity investors do not bear the residual economic risks. However, FIN 46R did not address the continuing unresolved questions about what constitutes important rights in partnerships that are not variable interest entities.

8. At its meeting in May 2004, the EITF Agenda Committee added this Issue (Issue 04-5) to the EITF agenda and decided that the scope should be broad and address the issue of which rights held by limited partner(s) preclude consolidation in circumstances in which the sole general partner would consolidate the limited partnership in accordance with generally accepted accounting principles (that is, the general partner controls the partnership) absent the existence of the rights held by the limited partners(s). Further, an Agenda Committee member noted that any consensus reached by the Task Force on this Issue should be reconciled to the important rights concept in SOP 78-9 to avoid different consolidation guidance for limited partnerships based on their industry.

Prior Task Force Discussion

9. At the June 30–July 1, 2004 EITF meeting the Task Force discussed the proposed approach for addressing this Issue as put forth by the FASB staff but was not asked to reach a consensus. The Task Force agreed with the proposed approach and generally agreed with the proposed framework but provided input to the FASB staff regarding the framework and scope of the Issue. That input has been used as the basis for the preparation of this Issue Summary Supplement.

Scope

10. The scope of this Issue is limited to investments in which the investor is the sole general partner in a limited partnership or similar entity (such as a limited liability company that has governing provisions that are the functional equivalent of a limited partnership) and the limited partnership is not a variable interest entity under FIN 46R. For purposes of this Issue, a *sole general partner* is a single investor or a single investor and its related parties that own all of the general partnership interests in a limited partnership being considered for consolidation. The investor's *related parties* are those parties defined as related parties in FAS 57. This Issue does not apply to general partners that, in accordance with generally accepted accounting principles, carry substantially all of their assets, including investments in controlled entities, at fair value with changes in value reported in a statement of net income or financial performance. This Issue also is not intended to change current practice regarding when it is and when it is not appropriate for a general partner to use the pro rata method of consolidation for its investment in a partnership.

Accounting Issue and Alternatives

Issue 1: When a sole general partner should consolidate a limited partnership.

11. The framework put forth below, which is supplemented by the discussion of Issue 2 later, is to be used by a sole general partner in a limited partnership to determine whether consolidation of the limited partnership is required. Discussion of the basis for the framework is included later in this Issue Summary Supplement:

General Approach

A sole general partner in a limited partnership is presumed to control that limited partnership and therefore should include the limited partnership in its consolidated financial statements. The assessment of whether the rights of the limited partners¹ should overcome the presumption of control, and therefore consolidation, by the sole general partner is a matter of judgment that depends on facts and circumstances. Such facts and circumstances should be evaluated based on the following two step process:

Step 1: Determine whether the limited partners have the substantive ability to dissolve (liquidate) the limited partnership or otherwise remove the sole general partner, without cause.² For purposes of this Issue, the limited partners' ability to dissolve (liquidate) the limited partnership or otherwise remove the sole general partner, are collectively referred to herein 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. However, withdrawal rights held by the limited partners that do not require dissolution or liquidation of the entire limited partnership would not overcome the presumption that the sole general partner controls the limited partnership (that is, the withdrawal right is not deemed to be a kick-out right). *The factors to be considered in determining whether kick-out rights held by limited partners are substantive is separately addressed in Issue 2 below and will subsequently be incorporated into Step 1 of the framework.*

If Yes: The presumption of control, and therefore consolidation, by the sole general partner would be overcome. The sole general partner should account for its investment in the limited partnership using the equity method of accounting.

If No: Proceed to Step 2

Step 2: Determine whether the limited partners have substantive participating rights. If the limited partners have substantive participating rights, the presumption of control, and therefore consolidation, by the sole general partner would be overcome.

This assessment of limited partner rights should be made when an investor becomes the sole general partner in a limited partnership and should be reassessed if (a) there is a significant change to the terms or in the exercisability of the rights of the limited partners, (b) the sole general partner significantly increases or decreases its ownership of limited partnership interests, or (c) there is a significant increase or decrease in the number of outstanding limited partnership interests.

¹ The term *limited partners* refers to one or more limited partners and shall have this meaning when used in the context of this Issue.

² *Without cause* means that no reason need be given for the dissolution of the limited partnership or removal of the general partner. *With cause* generally restricts the limited partners' ability to dissolve the limited partnership or remove the general partner to situations that include, but would not be limited to, fraud, illegal acts, gross negligence, and bankruptcy of the general partner. For

purposes of this Issue, dissolution of the partnership or removal *without cause* includes dissolution or removal due to poor performance of the general partner.

Substantive Participating Rights

Rights held by the limited partners in a limited partnership (whether granted by contract or by law) that would allow the 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 sole general partner controls, and therefore should consolidate, the limited partnership:

1. Selecting, terminating, and setting the compensation of management responsible for implementing the limited partnership's policies and procedures.
2. Establishing operating and capital decisions of the limited partnership, including budgets, in the ordinary course of business.
3. The sale or refinancing of limited partnership assets.
4. The acquisition of limited partnership assets.

In evaluating the limited partners' rights to determine whether or not they are substantive, participation means the ability of the limited partners to block actions proposed by the sole general partner. That is, the sole general partner 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 mean the ability of the limited partners to initiate actions.

The rights outlined above are considered to be illustrative of substantive participating rights and are not necessarily all-inclusive. It is believed that the rights noted above are participating rights because the rights allow the limited partners to effectively participate in 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 not the sole general partner), should be assessed based on the facts and circumstances to determine if they are substantive participating rights in and of themselves. However, limited partner rights that appear to be participating rights but that by themselves are not substantive (see "Factors to Consider") would not overcome the presumption of control, and therefore consolidation, by the sole general partner 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.

Factors to Consider

The following factors should be considered in evaluating whether limited partner 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 business.

1. The limited partnership agreement needs to be considered to determine at what level decisions are made—by the general partner or by the limited partnership as a whole—and, in addition, the rights of both the general partner and the limited partners should be considered. In all situations, any matters that can be put to a vote of the limited partnership must be considered to determine if 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.
2. Relationships between the sole general partner and the limited partners (other than investment in the common limited partnership) that are of a related-party nature, as defined in FAS 57, should be considered in determining if 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 sole general partner, then the rights of the limited partner likely would not overcome the presumption of control by the sole general partner.
3. Certain limited partner rights may deal with operating or capital decisions that are not significant to the ordinary course of business of the limited partnership. Limited partner 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 sole general partner. Examples of such rights that are not considered to be significant relate to decisions about location of 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.
4. Certain limited partner 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 existence of such limited partner rights should not overcome the presumption that the sole general partner consolidate, if it is remote⁴ that the event or transaction that requires limited partner approval will occur.
5. A sole general partner who has 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 if the participating rights of the limited partners are substantive. If such a buyout is feasible, and substantially within the control of the sole general partner, the sole

general partner's 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 sole general partner. It would not be "feasible, and substantially within the control of the sole general partner" to buy out the limited partners if, for example, (a) the limited partner(s) controls technology that is critical to the limited partnership or (b) the limited partner(s) is the principal source of funding available to the investee.

⁴Remote is defined in FAS 5 as "the chance of the future event or events occurring is slight."

Issue 2: In applying Step 1 of the framework, the factors to be considered in determining whether kick-out rights held by the limited partners are substantive and therefore would overcome the presumption of control by the sole general partner.

View A: Determination of whether kick-out rights held by the limited partners are substantive should be made by analogy to the guidance in paragraph B20 of FIN 46R.

12. Proponents of View A believe that paragraph B20 of FIN 46R represents the Board's description of what constitutes a substantive "kick-out" right. These proponents believe that the intent of the provisions of paragraph B20 of FIN 46R is the same intent that should be considered in determining whether the limited partners in a limited partnership have the means to dissolve the limited partnership or otherwise remove the sole general partner.

13. Paragraph B19 of FIN 46R states the following: "Fees paid to a decision maker shall not be considered variable interests if all of the following conditions exists: . . . d. The decision maker is subject to substantive kick-out rights, as that term is described in paragraph B20." The purpose of paragraph B19 is to determine whether the fees paid to a decision maker could be variable interests in evaluating whether the decision maker is the primary beneficiary of the variable interest entity (VIE). If the decision maker is not subject to substantive kick-out rights as described in paragraph B20 of FIN 46R, then the decision maker fees would be variable interests and would be considered in determination of the primary beneficiary. Therefore, the underlying purpose of determining whether kick-out rights are substantive under paragraph B19(d) is

consistent with the purpose of determining whether the kick-out rights are substantive in this Issue (that is, whether the sole general partner controls the limited partnership).

14. Because the intent of determining whether the kick-out rights are substantive is the same or similar in this Issue as it is in FIN 46R, proponents of View A believe that the characteristics used to determine whether kick-out rights are substantive should also be the same or similar. Therefore, these proponents believe that determination of whether the limited partners have substantive kick-out rights in a limited partnership should be determined as follows (Note: This framework is taken directly from paragraph B20 of FIN 46R; however, the wording has been revised to be consistent with the context of this Issue):

Substantive kick-out rights must have both of the following characteristics:

- a. The limited partnership can be dissolved (liquidated) or the sole general partner can be removed by the vote of a simple majority of the voting interests held by parties other than the sole general partner
- 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 the limited partnership or replacing the sole general partner that would act as a significant disincentive for dissolution or removal
 - (3) The absence of an adequate number of qualified replacement sole general partners or inadequate 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.

15. Proponents of View A believe that the above characteristics should be included in Step 1 of the framework in Issue 1 to establish the threshold for determining whether the kick-out rights

held by the limited partners are substantive, such that they would overcome the presumption that the sole general partner controls the limited partnership.

View B: Determination of whether kick-out rights held by the limited partners are substantive should be made on a facts and circumstances basis and should not be a simple majority as stipulated by the provisions of paragraph B20 of FIN 46R.

16. Proponents of View B believe that the determination of whether kick-out rights are substantive should be made on a different basis for entities that are variable interest entities than for entities that are not variable interest entities (that is, a voting interest entity). These proponents believe that variable interest entities are unique and specific consideration should be given to the voting rights of stakeholders in an entity that is a voting interest entity. Given the differences, these proponents put forth the following model to be included in Step 1 of the proposed framework:

Substantive kick-out rights are those rights that provide the limited partners with the ability to dissolve (liquidate) the limited partnership or otherwise remove the sole general partner by a reasonable vote of the limited partners without the limited partnership or the limited partners incurring a significant penalty.

In applying that criterion, the sole general partner should consider the following:

Reasonable Vote

For purposes of this Issue, reasonable vote encompasses the ability to call for a vote to dissolve the limited partnership or remove the sole general partner, and the ability to get the number of votes needed to actually require either action. Therefore, both of the requirements should be assessed to determine if the limited partnership can be dissolved or the sole general partner can be removed by a reasonable vote of the limited partners.

To begin the assessment, the number of votes necessary to call the vote and dissolve the limited partnership or remove the sole general partner (the greater of either the number of votes necessary to call for a vote to dissolve the limited partnership or remove the sole general partner or the number of votes necessary to actually require either action) should be calculated as a percentage of the number of votes held by limited partners that are not related parties to the sole general partner.³

Determining whether the required number of votes could be reasonably obtained is a matter of judgment that depends on facts and circumstances. The number of limited partners as well as the dispersion of ownership percentage are both important considerations when determining reasonableness. The larger the number of limited partners the less reasonable it may be that the necessary percentage of votes can be obtained. For example, it may be concluded that a requirement that 80 percent of the limited partners vote to dissolve the limited partnership or remove the general partner is reasonable for a limited partnership with only a few limited partners. However, a requirement that a vote of anything more than a simple majority of limited partners may not be reasonable for a limited partnership with numerous and widely disbursed limited partners (see "Examples").

Incurring a Significant Penalty

For purposes of this Issue, in evaluating the right to remove the sole general partner, incurring a significant penalty is when a significant requirement is imposed or can be imposed on the limited partnership or the limited partners to disburse cash, incur or assume a liability, perform services, surrender or transfer an asset or the rights to an asset or otherwise forego an economic benefit, or suffer an economic detriment. Examples of significant penalties to the limited partnership or the limited partners include, but are not limited to, removal of critical technology held by the sole general partner or removal of significant assets from the partnership, requirements that limited partnership or limited partners make a significant fixed payment or buy back the general partnership interest at a price significantly in excess of fair value, obligations to repay debt at a price significantly in excess of fair value, adverse tax consequences, and assumption of significant limited partnership obligations or liabilities.

In evaluating the right to dissolve (liquidate) the limited partnership, incurring a significant penalty is when a requirement is imposed or can be imposed on the limited partners to disburse cash, incur or assume a liability, perform services, surrender or transfer an asset, or otherwise forego an economic benefit, or suffer an economic detriment. Examples of significant penalties are similar to those included in the preceding paragraph.

In situations in which the significance of the penalty will vary with future events or circumstances, reasonably possible and probable significant penalties are considered significant penalties. When the likelihood of incurring a significant penalty is remote, the penalty should not be considered a significant penalty.

³ As defined in FAS 57 and including any limited partnership units held by the general partner. Related parties are defined in paragraph 24 of FAS 57 as follows:

Affiliates of the enterprise; entities for which investments are accounted for by the equity method by the enterprise; trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management; principal owners of the enterprise; its management; members of the immediate families of principal owners of the enterprise and its management; and other parties with which

the enterprise may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. Another party also is a related party if it can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

17. Consider the following examples to demonstrate application of View B under various scenarios:

Example A

An investor is the sole general partner in a limited partnership that has 99 limited partners. Each limited partner has one vote and 20 votes are required to call for a vote to dissolve the limited partnership or remove the general partner while 40 votes are required to actually require either action without cause. Four of the 99 limited partners are related parties of the general partner. There is no penalty to the limited partnership or the limited partners if the partnership is dissolved or the sole general partner is removed. The percentage of non-related-party limited partner votes required to carry either action is calculated as follows:

$$\frac{\text{The greater of either the number of votes necessary to call a vote to dissolve the limited partnership or remove the general partner or the number of votes necessary to actually require either action}}{\text{Number of votes held by limited partners that are not related parties to the general partner}} = 40 \div (99 - 4) = 42\%$$

Based on the circumstances of this example where there are numerous limited partners, a 42 percent vote is deemed reasonably obtainable and the presumption of consolidation by the investor who is the sole general partner would be overcome.

Example B

An investor is the sole general partner in a limited partnership that has 99 limited partners. Each limited partner has one vote and 70 votes are required to call for a vote to dissolve the limited partnership or remove the general partner while 40 votes are required to actually require either action without cause. Four of the 99 limited partners are related parties of the general partner. There is no penalty to the limited partnership or the limited partners if the partnership is dissolved or the general partner is removed. The percentage of non-related-party limited partner votes required to carry either action is calculated as follows:

$$\frac{\text{The greater of either the number of votes necessary to call a vote to dissolve the limited partnership or remove the general partner or the number of votes necessary to actually require either action}}{\text{Number of votes held by limited partners that are not related parties to the general partner}} = 70 \div (99 - 4) = 74\%$$

Based on the circumstances of this example where there are numerous limited partners, a 74 percent vote is not deemed reasonably obtainable and the presumption of consolidation by the investor who is the sole general partner would not be overcome. The investor should apply the guidance in Step 2 of the framework to the limited partnership. If the limited partners hold substantive participating right(s), the presumption of consolidation by the investor who is the sole general partner would be overcome. If the limited partners do not hold substantive participating right(s), the presumption of consolidation by the investor who is the sole general partner would not be overcome.

Example C

An investor is the sole general partner in a limited partnership that has six limited partners. One limited partner has four limited partnership units while the other five limited partners each have one limited partnership unit. Each partnership unit is entitled to one vote and six votes are required to call for a vote to dissolve the limited partnership or remove the general partner while four votes are required to actually require either action without cause. None of the limited partners is a related party of the general partner. There is no penalty to the limited partnership or the limited partners if the partnership is dissolved or the general partner is removed. The percentage of non-related-party limited partner votes required to carry either action is calculated as follows:

$$\frac{\begin{array}{c} \text{The greater of either the number of votes necessary to call} \\ \text{a vote to dissolve the limited partnership or remove the} \\ \text{general partner or the number} \\ \text{of votes necessary to actually require either action} \end{array}}{\begin{array}{c} \text{Number of votes held by limited partners that are not} \\ \text{related parties to the general partner} \end{array}} = 6 \div 9 = 67\%$$

Based on the circumstances of this example where there are a small number of limited partners with one limited partner holding a concentration of limited partnership units, a 67 percent vote is deemed reasonably obtainable and the presumption of consolidation by the investor who is the sole general partner would be overcome.

Example D

An investor is the sole general partner in a limited partnership that has six limited partners. One limited partner has four limited partnership units while the other five limited partners each have one limited partnership unit. Each limited partnership unit is entitled to one vote and four votes are required to call for a vote to dissolve the limited partnership or remove the sole general partner while eight votes are required to actually require either action without cause. None of the six limited partners is a related party of the general partner. There is no penalty to the limited partnership or the limited partners if the partnership is dissolved or the general partner is removed. The percentage of non-related-party limited partner votes required to carry either action is calculated as follows:

$$\frac{\text{The greater of either the number of votes necessary to call a vote to dissolve the limited partnership or remove the general partner or the number of votes necessary to actually require either action}}{\text{Number of votes held by limited partners that are not related parties to the general partner}} = 8 \div 9 = 89\%$$

Although there are a small number of limited partners with one limited partner holding a concentration of limited partnership units, based on the circumstances of this example, an 89 percent vote is not deemed reasonably obtainable and the presumption of consolidation by the investor who is the sole general partner would not be overcome. The investor should apply the guidance in Step 2 of the framework to the limited partnership. If the limited partners hold a substantive participating right(s), the presumption of consolidation by the investor who is the sole general partner would be overcome. If the limited partners do not hold a substantive participating right(s), the presumption of consolidation by the investor who is the sole general partner would not be overcome.

Reconciliation to the Provisions of SOP 78-9

18. The scope of this issue applies to all investments in limited partnerships where the investor is the sole general partner (as defined in this Issue) of the limited partnership. This would include investments in real estate limited partnerships that are subject to the guidance in SOP 78-9 (specifically paragraphs .08 through .10). As it relates to investments in real estate limited partnerships, the FASB staff believes that the guidance included in this Issue is interpretive of the guidance provided in SOP 78-9. The FASB staff believes that the framework provided above is consistent with the "important rights" concept of paragraph .09 of SOP 78-9 and therefore does not amend the guidance in the SOP. Paragraph .09 states the following:

The rights and obligations of the general partners in a limited partnership are different from those of the limited partners. Some believe that general partners should be deemed to have the controlling interest in a limited partnership. However, if limited partners have **important rights**, such as the right to replace the general partner or partners, approve the sale or refinancing of principal assets, or approve the acquisition of principal partnership assets, the partnership may not be under the control, directly or indirectly, of the general partnership interests. The division believes that the general partners are in control and should account for their investments in accordance with the recommendations in paragraph .07³

³ Paragraph 7 of SOP 78-9 states that "The division believes that a controlling investor should account for its investment under the principles of accounting applicable to investments in subsidiaries."

only if the substance of the partnership or other agreements provides for control by the general partners. [Emphasis and footnote reference added.]

19. The FASB staff believes that the important rights concept in paragraph .09 can be reconciled to the guidance in this Issue as follows:

Important rights. – In this Issue, an important right would be any right conveyed to the limited partners that would preclude consolidation by the sole general partner. Therefore, those rights included in Step 1 and Step 2 of the proposed framework would be important rights if they overcome the presumption of control by the sole general partner.

The right to replace the general partner or partners - This concept is specifically addressed in Step 1 of the proposed framework and is consistent with the concept included in the SOP.

The right to approve the sale or refinancing of principal assets - Step 2 of the proposed framework incorporates the notion that substantive participating rights held by the limited partners would overcome the presumption that the limited partnership is controlled by the sole general partner. One of the illustrative examples of a substantive participating right is the right of the limited partners to approve the sale or refinancing of limited partnership assets. The sale or refinancing of limited partnership assets would encompass the "principal assets" of a limited partnership engaged in real estate activities. Therefore, if the limited partners possess that right, Step 2 of the proposed framework would indicate that this right is a substantive participating right that would overcome the presumption of control by the sole general partner. Accordingly, in that regard the proposed framework is consistent with the important rights concept included in the SOP.

The right to approve the acquisition of principal partnership assets - Again, under Step 2 of the proposed framework, one of the illustrative examples of a substantive participating right is the right of the limited partners to approve the acquisition of limited partnership assets. The acquisition of limited partnership assets would encompass the "principal partnership assets" of a limited partnership engaged in real estate activities. Therefore,

such a right held by the limited partners would be evaluated as a substantive participating right in Step 2 of the framework that would overcome the presumption of control by the sole general partner. In that regard the proposed framework is consistent with the important rights concept included in the SOP.

Consideration of Specific Questions Raised in Practice

20. This Issue was brought to the EITF Agenda Committee because of the perceived need to address the consolidation of investment partnerships by the sole general partner that are not variable interest entities under FIN 46R. The Issue was intended to address whether certain limited partners' rights should be considered important rights as described in SOP 78-9 and therefore would preclude consolidation by the general partner. Specifically, the following issues were raised for consideration:

1. Whether certain rights of limited partners other than rights to replace the general partner should be considered important rights under SOP 78-9, specifically:
 - (a) The limited partners right to dissolve or liquidate the partnership without incurring a significant economic penalty (liquidation rights), and
 - (b) The limited partners' unilateral right to withdraw from the partnership in whole or in part without incurring a significant economic penalty (withdrawal rights).
2. If the rights in points 1(a) and 1(b) could be important rights under SOP 78-9, the characteristics the liquidation rights or withdrawal rights should possess in order to be considered substantive.

21. The FASB staff has developed the proposed framework above with those issues in mind and believes that they can be specifically addressed under the proposed framework. With regard to point 1(a), the limited partners right to dissolve or liquidate the partnership without incurring a significant economic penalty (liquidation right) is specifically included in Step 1 of the framework as a right that, if substantive, could overcome the presumption of control by the sole general partner. Determination of what characteristics the liquidation right must possess in order

to be considered substantive is also considered in the framework and is specifically addressed in Issue 2.

22. With regard to point 1(b), while all forms of withdrawal rights have not been specifically addressed in the proposed framework, some argue that withdrawal rights are akin to liquidation rights and therefore should be analyzed under Step 1 of the proposed framework. Determination of whether the withdrawal right has substance and therefore would overcome the presumption of control by the sole general partner is dependent upon facts and circumstances. While the specific terms of withdrawal rights should be evaluated under the proposed framework, the FASB staff observes that a "simple" withdrawal right that does not require dissolution or liquidation of the entire limited partnership, would not overcome the presumption that the sole general partner controls the limited partnership (that is, the withdrawal right is not deemed to be a kick-out right). That "observation" has been specifically included in Step 1 of the proposed framework.

Basis for Proposed Framework

General Approach

23. The general approach in the proposed framework is primarily derived from the legal rights and obligations of a general partner in a limited partnership. In the United States, the 1976 Uniform Limited Partnership Act (the Act) defines a limited partnership as a partnership formed by two or more entities that has one or more general partners and one or more limited partners. The Act imposes significant restrictions on limited partners' rights to "participate in the control of the business" as a condition for releasing them from joint and several liability for the obligations of the partnership. Thus, those specific statutory limitations on the control of limited partners generally confer the decision-making to the control of the general partners.

24. Further, those restrictions on limited partners usually give the sole general partner the ability to establish the partnership's capital and operating budgets, hire its personnel, and otherwise direct the use of its assets in essentially the same ways that the sole general partner can direct the use of its own assets. For those reasons, the framework begins with the presumption that the sole general partner in a limited partnership controls the limited partnership and, therefore, it should

include the assets, liabilities, results of operations, and cash flows of the limited partnership in its consolidated financial statements.

Step 1

25. The presumption that the sole general partner should consolidate a limited partnership can be overcome in Step 1 if the limited partners have the current ability to dissolve (liquidate) the limited partnership or otherwise remove the sole general partner. The exception to the general presumption in Step 1 is predicated on the fact that if the limited partners have the current ability to remove the sole general partner, the limited partners merely have delegated decision making powers to the general partner, and thus the general partner serves at the convenience of the limited partners.

26. The limited partners of a limited partnership may also have the current ability to dissolve (liquidate) the partnership. In that case, the limited partners could establish a new limited partnership with a new sole general partner to pursue the same objectives of the dissolved limited partnership. That right and ability of the limited partners to liquidate the partnership has effectively the same influence on the control of the limited partnership as the right of the limited partners to remove the sole general partner (that is, in either case, the assets and activities of the limited partnership can effectively continue under the direction of a new sole general partner). For that reason, the framework puts forth the notion that both of the limited partners' abilities to remove the sole general partner and dissolve (liquidate) the partnership should be analyzed together and should be collectively referred to as "kick-out rights" for purposes of overcoming the presumption of control by the sole general partner.

27. Determining whether the kick-out rights held by the limited partners are substantive requires significant judgment based upon the facts and circumstances in each situation. While the limited partners' ability to remove the general partner would appear to be different from its ability to dissolve (liquidate) the limited partnership, determination of whether its ability to force either of those actions has substance should be assessed in the same manner. The question of whether kick-out rights held by the limited partners are substantive is addressed in Issue 2.

Step 2

28. Under Step 2 of the framework, if the limited partners do not have the ability to dissolve (liquidate) the limited partnership or otherwise remove the sole general partner, the presumption of control may be overcome by the existence of substantive participating rights.

29. That concept is similar to substantive participating rights in Issue 96-16. Under Issue 96-16, minority rights are deemed to be substantive and therefore would overcome the presumption of consolidation by the majority voting interest if those rights allow the minority shareholder to effectively participate in significant decisions that would be expected to be made in the "ordinary course of business." Minority rights that possess those characteristics are called "Substantive Participating Rights" in Issue 96-16. Since those rights possess similar characteristics of rights held by limited partners that would overcome the presumption of consolidation by the sole general partner, Step 2 incorporates the concept of substantive participating rights into the framework for determining whether the general principle is overcome.

30. Step 2 of the proposed framework includes as substantive participating rights the limited partners' rights to approve the sale or refinancing of limited partnership assets and the right to approve the acquisition of limited partnership assets. Those rights were added to encompass the "important rights" concept of SOP 78-9 in to the model developed in this Issue. The FASB staff acknowledges that, with the inclusion of those rights as participating rights, the threshold for overcoming the presumption of consolidation by the sole general partner in this Issue may be less stringent than the threshold for overcoming the presumption of consolidation by the majority shareholder in Issue 96-16. That difference arises because the minority shareholders' right to block (and, therefore, by default, approve) acquisitions and dispositions of assets greater than 20 percent of the fair value of the investee's total assets is a protective right in Issue 96-16. Rights deemed to be protective rights in Issue 96-16 do not overcome the presumption of consolidation by the majority shareholder. The staff believes that this difference is warranted in the context of addressing the consolidation of limited partnerships given the nature and, often times, limited investment and operational objectives of limited partnership entities.

Transition

31. It is expected that a consensus on this Issue may result in a significant change in the accounting for a sole general partner's investment in a limited partnership. Accordingly, the FASB staff believes that the Task Force should consider transition alternatives. The transition alternatives to be considered are as follows:

View A: Transition for a consensus on this Issue should be consistent with the transition provided in Issue 96-16 since the effect of a consensus on current practice is similar to the effect of Issue 96-16 on practice at that time.

32. Under this transition alternative the guidance in this Issue will be effective upon ratification of the consensus by the Board (October 13, 2004) for all new limited partnership agreements and for existing limited partnership agreements that are modified subsequent to that date and the application of either Transition Method A or Transition Method B, described below, will be acceptable.

Transition Method A

33. For existing limited partnership agreements that have not been modified, the guidance should be applied in financial statements issued for reporting periods beginning after June 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 third quarter of 2005 based on agreements in effect at the time of adoption. If, however, the guidance is adopted during an interim period other than the first interim period of the year of change, all prior interim periods of that fiscal year should be restated.

34. 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 items (a)-(c) paragraph 19 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 partnership 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.

35. Generally, changes in accounting for an investment 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*.⁴

Transition Method B

36. Alternatively, for existing limited partnership agreements that have not been modified, this guidance should be applied in financial statements issued for fiscal periods beginning after June 15, 2005 (earlier application is encouraged) with financial statements of prior periods restated in accordance with the provisions of paragraphs 27-30, 34, and 35 of APB 20. If an entity applies this guidance retroactively, it should apply it to all limited partnership agreements based on the facts and circumstances at the time each investment was made and 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*⁴ in the financial statements under Transition Method B.

View B: The guidance in this consensus is effective for financial statements for reporting periods beginning after June 15, 2005 and all interim periods in the year of adoption. Earlier application is encouraged. Comparative financial statements for earlier periods, if provided, including those of the period of adoption shall be restated when this consensus is first applied. However, in the period the consensus is first applied, retroactive restatement is not required for those limited partnership investments for which control by the sole general partner was

⁴ See transition discussion in Issue 96-16.

relinquished by sale or otherwise prior to the adoption of this consensus (that is, the limited partnership agreement was modified prior to the effective date of this consensus).

View C: The guidance in this consensus is effective upon ratification by the Board (October 13, 2004) for all new limited partnership agreements and for existing limited partnership agreements that are modified subsequent to that date.