

**Morgan Stanley**

Letter of Comment No: 3  
File Reference: FSPSOP789A

February 18, 2005

Ms. Suzanne Q. Bielstein  
Director – Major Projects and Technical Activities  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

**Re: File Reference No. EITF0405, Draft EITF Abstract – “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” (“Proposed EITF 04-5”)**

**Re: File Reference No. FSPSOP78-9-a, Proposed FASB Staff Position – Interaction of AICPA Statement of Position 78-9, “Accounting for Investments in Real Estate Ventures” (“SOP 78-9”), 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” (“Proposed FSP”)**

**The above references are defined herein as the “Proposed Guidance.”**

Dear Ms. Bielstein:

Morgan Stanley appreciates the opportunity to provide comments in response to the Proposed Guidance to determine which party should consolidate a limited partnership. Limited partnership and similar entities that are not “variable interest entities” as defined in FASB Interpretation No. 46 (revised December 2003) (“FIN 46R”), “*Consolidation of Variable Interest Entities*,” are quite prevalent and there is varied guidance available to assist in determining the party (i.e., the general partner or limited partner(s)) with which “control” resides. In reviewing the Proposed Guidance, we have noted several concerns and inconsistencies that are discussed below.

***Percentage of Ownership Interest and the Presumption of Control***

Paragraph 5 of Proposed EITF 04-5 asserts that the presumption of control in a limited partnership entity resides with the sole general partner “...regardless of the sole general partner’s ownership interest in the limited partnership.” Paragraph 19.a. of “Factors to Consider” indicates that a partner’s percentage of ownership interest should be considered

in assessing whether limited partner rights are substantive participating rights and, therefore, evidence of control. However, an ownership or economic interest in the partnership entity that is at least significant is not a *requirement* for consolidation under Proposed EITF 04-5. We believe that in order for the sole general partner to be deemed the appropriate party to consolidate a limited partnership the general partner should hold at least a significant financial interest in the partnership entity. The presumption in Proposed EITF 04-5 that the sole general partner controls, and therefore, is the appropriate party to consolidate the partnership entity regardless of the general partner's ownership or economic interest is inconsistent with consolidation guidance prescribed by several other current accounting standards.

- Accounting Research Bulletin No. 51 ("ARB 51"), "*Consolidated Financial Statements*," requires a "**controlling financial interest**," which is typically evidenced by "...ownership of a **majority voting interest**" as the premise for consolidation. While ARB 51 acknowledges that exceptions to this general rule for consolidation can exist, a controlling financial interest is the principal condition for determining consolidation. This concept is affirmed in Statement of Financial Accounting Standards No. 94 ("SFAS 94"), "*Consolidation of All-Majority-Owned Subsidiaries*," which amended ARB 51 as the principal authoritative pronouncement for consolidation.
- Consolidation guidance in EITF Issue No. 97-2 ("EITF 97-2"), "*Application of FASB Statement No. 94 and APB Opinion No. 16 to Physician Practice Management Entities and Certain Other Entities with Contractual Management Arrangements*," discusses whether a controlling financial interest may be established via a contractual management arrangement versus the ownership of a majority voting interest. The consensus reached in EITF 97-2 is that such a controlling financial interest can be established via a contractual arrangement as long as an entity has *both* the "control" over and a "financial interest" in another entity. EITF 97-2 further elaborates on the notion of a "financial interest" and states that an entity "...must have a **significant financial interest** in the physician practice..." Therefore, even if significant decision making abilities reside with an entity, consolidation is not appropriate if the entity lacks a significant interest in the economics of the physician practice entity. It has been noted by the SEC Observer that EITF 97-2 is not limited strictly to physician practice entities and may be applied to other entities in other industries with similar arrangements, which would include those instances where one entity has a controlling financial interest in another through...[a] contractual arrangement. As the decision making abilities of the general partner in a limited partnership are set forth in a similar contractual arrangement (i.e., the partnership agreement), we see no reason to treat these arrangements differently.
- Paragraph 7 of SOP 78-9, states that in evaluating the control and, therefore, consolidation of a general partnership "...a condition that would usually indicate control is ownership of a **majority (over 50 percent) of the financial interests** in profits or losses." While SOP 78-9 notes that factors may exist whereby a "...majority ownership may not constitute control..." the underlying premise for consolidation of the general partnership is control via a majority financial interest.

- Guidance in EITF Issue No. 96-16 (“EITF 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,*” acknowledges that a **controlling financial interest** in an entity is typically evidenced by ownership of a **majority voting interest** although, in some instances, the minority shareholder’s may hold certain rights that if deemed to be “substantive participating rights” can overcome the presumption of control by the majority owner.
- FIN 46R requires an evaluation of a **controlling financial interest** using the concept of a **majority financial interest** when addressing the consolidation of variable interest entities. Under FIN 46R, an entity is required to consolidate a variable interest entity if the entity “...has a variable interest...that will absorb a majority of the entity’s expected losses, receive a majority of the entity’s expected residual returns, or both.”

In the absence of substantive kick-out or participating rights, the Proposed Guidance in its current form would require the consolidation of a limited partnership by a general partner owning only a nominal (e.g., one percent or less) financial interest in the entity. As a result, the general partner would be required to report partnership assets to which it is not entitled and partnership liabilities that it is not obligated to pay in addition to a substantial amount of minority interest (e.g., ninety-nine percent or more). Such reporting will not be relevant to financial statement users and presents a misleading picture of the general partner’s financial position and nature of operations. While we acknowledge that control may be difficult to discern in certain arrangements, we believe that there may be instances in which a general partner functions more akin to a service provider within the confines of the partnership agreement agreed to by the limited partners; thus challenging the presumption of general partner control, legal liability notwithstanding. Further, we believe the starting presumption that control resides with the general partner is inconsistent with the overarching premises previously articulated in existing accounting literature.

We recommend revising paragraph 5 of Proposed EITF 04-5 to state: “[a] sole general partner **with at least a significant financial interest** in a limited partnership is presumed to control that limited partnership and therefore should include the limited partnership in its consolidated financial statements.” Steps 1 and 2 in the Proposed Guidance should then be applied to determine if the rights held by the limited partners are substantive enough as to overcome the presumption of control by the sole general partner holding at least a significant financial interest.

### ***Decision Making and Conflicts with FIN 46R***

Paragraph 18 of the Proposed EITF 04-5 states that “[i]ndividual 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 sole general partner) should be assessed based on the facts and circumstances to determine if they are substantive participating rights in and of themselves.” If the management is outsourced as stated in the parenthetical reference and the rights related to the removal of the third party decision maker are not substantive, wouldn’t the limited partnership actually meet the definition of a variable interest entity, and therefore, not be

subject to the Proposed Guidance? Paragraph 5.b.(1) of FIN 46R states that one of the criteria for an entity to be deemed a variable interest entity is if “[a]s a group the holders of the equity investment at risk lack...[t]he direct or indirect ability through voting rights or similar rights to make decisions about an entity’s activities that have a significant effect on the success of the entity.” The rights of both the general partner and the limited partners would need to be evaluated to determine if as a whole the rights to “kick out” the third party decision maker are substantive. If it is determined that the kick out rights are not substantive and the partners as a group lack decision making ability since all decision-making has been outsourced by contract to a party who is not an equity interest holder, the limited partnership would be deemed a variable interest entity and scoped out of the Proposed Guidance.

We suggest the Task Force remove the parenthetical reference above since an assessment of general and limited partner rights related to the removal of an outsourced decision maker would first be required in order to determine if the partnership entity is a variable interest entity within the scope of FIN 46R.

Additional guidance in paragraph 5.c. of FIN 46R further clarifies that the equity investors as a group are considered to lack the decision making ability discussed in paragraph 5.b. (1) if: “...(i) the voting rights of some investors are not proportional to their obligations to absorb the expected losses of the entity, their rights to receive the expected residual returns of the entity, or both and (ii) substantially all of the entity’s activities...either involve or are conducted on behalf of an investor that has disproportionately few voting rights.” Footnote 11 of FIN 46R explains that this stipulation “...is necessary to prevent a primary beneficiary from avoiding consolidation of a variable interest entity by organizing the entity with *nonsubstantive* voting interests.” Given these provisions within FIN 46R, it is not apparent how a limited partnership that is structured whereby the limited partners hold a majority financial interest and the sole general partner holds a nominal interest would be within the scope of the Proposed Guidance if the limited partners have rights that are not deemed to be “substantive.” In such instances it seems that the limited partnership would meet the definition of a variable interest entity as per paragraph 5.c. cited above and, therefore, be scoped out of the Proposed Guidance. We ask that the Task Force clarify as to when a limited partnership entity whose limited partners do not have substantive rights would overcome the criteria of FIN 46R and be subject to the Proposed Guidance.

### ***Thresholds for Evaluation of Substantive Participating Rights***

If it is determined that the limited partners lack substantive kick-out rights as per Step 1 of the consolidation model in the Proposed Guidance, Step 2 would then be necessary to evaluate whether the limited partners rights are “substantive participating rights.” Paragraph 10 defines substantive participating rights as rights that “...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.”

In evaluating whether the rights of the limited partners related to significant decisions expected to be made in the ordinary course of business are substantive, paragraph 18 states

that "...[t]he 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." We agree that such consideration should not be required in evaluating the substantive nature of the limited partners rights and believe that the existence of the right itself should be the focal point in determining whether the presumption of control by the general partner has been overcome. Whether the limited partners will choose to exercise their right or not should be irrelevant.

Paragraph 12 states that in assessing whether limited partner rights related to significant decisions made in the ordinary course of business are substantive enough as to overcome the presumption of control by the general partner "...[i]t must be at least *reasonably possible* that those events or transactions that would necessitate such decisions will occur." In contrast, additional guidance in paragraph 19.(e) states that "...the Task Force concluded that the existence of such limited partners' rights should not overcome the presumption that the sole general partner should consolidate if it is *remote* that the event or transaction that requires the limited partners' approval will occur." In addition to being contradictory of each other, the "reasonably possible" and "remote" thresholds in paragraphs 12 and 19.(e) are not clearly defined in the Proposed Guidance. This will result in an inconsistent interpretation of these terms by those evaluating limited partner rights and noncomparability in financial reporting.

We recommend that the Task Force remove the "reasonably possible" and "remote" thresholds in paragraphs 12 and 19.(e) as such probability assessments are highly subjective. A similar threshold is not required in paragraph 18 in order to assess the probability of the limited partners actually exercising their rights, and as we previously commented the existence of the right should be the driving factor in the assessment. Paragraphs 12 and 19.(e) may alternatively be revised to require that "...such decisions must relate to events or transactions that *could* occur during the ordinary course of business" if there are concerns about nonsubstantive provisions being incorporated as a means to avoid the spirit of the consolidation guidance.

### ***Transition***

While we concur with the transition provisions for new and existing limited partnerships that have been modified, we believe existing limited partnerships for which the partnership agreements have not been modified should be exempt from the provisions of the Proposed Guidance. Requiring the provisions in the Proposed Guidance to be effective for existing partnerships that have not been modified will result in each limited partnership being re-analyzed to address criteria that was not present at the time the partnership was structured. Such a task will likely prove time consuming and operationally burdensome without much benefit to users of financial statements. In addition, amending existing agreements may not be practical as the limited partners themselves may not be willing to allow for a lowering of the threshold for displacing the general partner given the limited partners' comfort level with the existing general partner's role, which was a key component of the limited partners' investment decision.

***Proposed Amendments of EITF 96-16 and SOP 78-9***

With regard to adding the provisions in paragraphs 19.b.(1) and 19.b.(2) of the Proposed EITF 04-5 to EITF 96-16, we believe a preferable alternative would be to first revise the Proposed EITF 04-5 to require that the sole general partner hold at least a significant financial interest as a premise for consolidation by the general partner. This premise is compatible with that of EITF 96-16 in its current form which, as noted above, presumes consolidation resides with the investor holding a controlling financial interest (evidenced via a majority voting interest) in the entity and focuses on circumstances in which this presumption can be overcome by the rights of the minority owners.

We suggest the Task Force consider including the entities subject to EITF 96-16 within the scope of the Proposed EITF 04-5, thereby, creating a single standard to assess when rights of the minority interest holder(s) (e.g., limited partners, minority shareholders) overcome the presumption of control and consolidation by the holder of at least a significant financial interest. We also note that EITF 96-16 contains the same inconsistent and highly subjective “reasonably possible” and “remote” threshold requirements to evaluate whether minority rights are deemed to be substantive participating rights. Such inconsistencies could be resolved as a single standard is developed.

Additionally, we recommend that instead of revising paragraphs 7 and 9 of SOP 78-9 via the Proposed FSP, these paragraphs should be superceded and guidance addressing the consolidation of both a general and limited partnership by a general partner holding at least a significant financial interest be incorporated into the Proposed EITF 04-5 as part of a single standard. Further, we observe that an inconsistency exists in the premise for consolidation between paragraphs 7 and 9 of the Proposed FSP, in that paragraph 7, which addresses general partnership structures, acknowledges that control is evidenced via the ownership of a majority financial interest. (This acknowledgement is also made in SOP 78-9 in its current form and is noted above in our comments related to “Percentage of Ownership Interest and the Presumption of Control”). Paragraph 9 that addresses limited partnership structures conversely states that control is presumed to reside with the general partners and does not state whether consideration, if any, should be given to the percentage of the general partners financial interest in the partnership entity. We believe such inconsistencies should be resolved and can be achieved by the development of a single standard.

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We appreciate the Board's effort to provide guidance to assess when a sole general partner should consolidate its investment in a limited partnership. However, we have noted several inconsistencies within the Proposed Guidance as well as with the other current accounting standards.

We would be pleased to discuss our comments with the Board or Staff. Please contact Karen Dealey at (212) 537-2452, Staci Lublin at (212) 537-2456 or myself at (212) 537-2620 with questions or comments.

Sincerely,

/s/ David S. Moser  
Managing Director  
Principal Accounting Officer