

February 18, 2005

Mr. Lawrence W. Smith
Director, Technical Application and Implementation
Financial Accounting Standards Board
401 Merritt 7
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Letter of Comment No: 2
File Reference: FSPSOP789A

File Reference Nos. FSPSOP78-9-a, EITF0405

Dear Mr. Smith:

The Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants is pleased to offer comments on the FASB's 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,'" and the draft abstract for EITF Issue No. 04-5.

AcSEC supports the Emerging Issues Task Force's (the Task Force's), FASB staff's, and Board's objective of providing guidance on a general partner's accounting for its investment in a limited partnership and conforming SOP 78-9 to such guidance. Following are AcSEC's comments and recommendations on a number of aspects of the proposed EITF Issue and FSP.

Principal Comments and Recommendations

1. AcSEC does not believe that issuance of the proposed guidance obviates the need for the Board to continue to strive for issuance of general principles on consolidation for all entities (variable interest and non-variable-interest). AcSEC believes further that the Board should develop broader guidance on the accounting for general partnerships, limited partnerships, limited liability companies, and similar structures that use specific ownership accounts (as AcSEC sought to achieve in its SOP project to revise SOP 78-9), including the associated consolidation issues. In practice, the principles of SOP 78-9 are applied by analogy to many more industries and entities than real estate ventures—for example, hedge funds and venture capital funds—and AcSEC believes that the Board should consider issuing guidance that explicitly acknowledges and discusses the broader applicability of that SOP's principles.

2. AcSEC believes the proposed guidance is a reasonable extension to partnerships of the guidance for corporate entities in 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.” However, AcSEC observes that the proposed EITF Issue and FSP could require the consolidation of a limited partnership by a general partner who owns a nominal interest in that partnership. For example, the proposed guidance appears to lead to the conclusion that a general partner, owning a one percent interest in a real estate limited partnership in which the rights of the limited partners do not include kick-out rights or substantive participating rights, should consolidate the partnership. In that case, the general partner would include all of the partnership’s debt on the general partner’s balance sheet even though the debt may be nonrecourse and the general partner’s interest is nominal. Moreover, the general partner’s balance sheet would include minority interest of nearly one hundred percent. Some AcSEC members question the meaningfulness of the resulting consolidated financial statements. AcSEC recommends that, if it has not already done so, the Board actively solicit views from lenders, investors, and other users as to the usefulness of consolidated financial statements of nominally invested general partners—for example, the one percent general partner’s consolidated financial statements in the above example.

3. Under paragraph 6(a) of the proposed EITF Issue, if kick-out rights can be exercised by a vote of no more than a simple majority of the voting interests held by parties other than the sole general partner, the rights possess one of the two required characteristics to be considered substantive for purposes of overcoming the presumption of control by the general partner. AcSEC is not convinced that a simple majority bright line threshold is appropriate in all circumstances and believes there may be circumstances in which another threshold—for example, a supermajority—is appropriate. AcSEC questions why the Task Force (and ultimately the Board in its oversight role) did not apply instead the concept of “reasonable vote” as discussed in paragraph 4 of 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”:

The Task Force did not object to the general concepts proposed by the working group, including the notion that a partnership agreement that provides for the removal of the general partner by a reasonable vote of the limited partners, without cause, and without the limited partners or partnership incurring a significant penalty, indicates that the sole general partner does not control the limited partnership.

AcSEC believes the “reasonable vote” concept may better take into account the spectrum of scenarios under which limited partners may be able to remove a general partner. In certain cases AcSEC believes that a supermajority vote to remove a general partner may indicate that the general partner does not control the partnership. For example, for a limited partnership with six limited partners, a requirement for a vote of “two-thirds or more” of the limited partners to remove the general partner might be considered reasonable to overcome the presumption of control by the general partner. On the other hand, in a limited partnership with thousands of limited partners that are widely dispersed geographically, a requirement for a vote of two-thirds (say) of the limited partners to remove the general partner may not be appropriate and may be too onerous in overcoming the presumption of control by the general partner because of the difficulty of obtaining a high response rate to a request for a vote, let alone a high percentage of votes in favor of removal, from a large, widely dispersed group.

If the Task Force adopts a “reasonable vote” concept, AcSEC believes one or more illustrative examples of how that guidance should be applied would be helpful.

4. Paragraph 14(d) of the proposed EITF Issue states that rights of the limited partners to block acquisitions and dispositions greater than 20 percent of the fair value of the limited partnership’s total assets would be considered protective rights and therefore would not overcome the presumption of control by the general partner. AcSEC questions whether the 20 percent bright line threshold is an appropriate standard. For example, consider a real estate limited partnership that owns and operates three basically identical properties that it intends to sell after 5 to 7 years, and which together constitute virtually all of the partnership’s assets. In view of the partnership’s general business plan, the sales would appear to be in the “ordinary course of business” (as that phrase is used in paragraph 16(b) of the proposed EITF Issue) and, therefore, decisions on sales would seem to be participating rights. However, because each property constitutes about 33 percent (more than 20 percent) of the partnership’s total assets, the limited partners’ rights to approve or disapprove sales would be considered protective rights. (This issue becomes even more pronounced when the partnership’s assets consist primarily of a single property.) AcSEC believes that, both with respect to the proposed EITF Issue and EITF Issue No. 96-16, the Task Force should consider indicating that the 20 percent bright line may not be appropriate and individual facts and circumstances should be considered. In addition, one or more illustrative examples of how the “ordinary course of business” guidance should be applied would be helpful.

Other Comments and Recommendations on Specific Paragraphs in the Proposed Guidance

Proposed FSP

5. The amendment to paragraph .07 of SOP 78-9 (paragraph 4 of the proposed FSP) considers the effects of substantive participating rights on control with respect to the majority interest holder in a general partnership. Although not commonly encountered in practice, a general partnership agreement (or an agreement for an LLC with a managing member) might contain kick-out rights not unlike those in a limited partnership agreement. AcSEC believes that if kick-out rights are to be considered in determining whether control exists in a limited partnership (as they are under paragraph .09 of the proposed FSP), the Board should consider providing guidance in paragraph .07 on whether kick-out rights should be similarly considered with respect to a general partnership.

6. The amendment to paragraph .09 of SOP 78-9 (paragraph 5 of the proposed FSP) states that if the presumption of control is not overcome and a single general partner, including a single investor and its related parties, controls the limited partnership, that general partner should consolidate the limited partnership. If a single investor and its related parties is deemed to control the partnership, it is unclear how to determine which of the related parties should consolidate the limited partnership. It would be helpful for the revised SOP to include guidance and examples addressing consolidation by a related

party group as mentioned in paragraph .09. (Similarly, paragraph 3 of the proposed EITF Issue defines a “sole general partner” as a single investor or a single investor and its related parties. Here too, in situations in which the sole general partner is to consolidate the limited partnership, it is unclear which party in the related party group should consolidate.)

AcSEC recommends also that the Board consider whether “related parties” in paragraph .09 should include related parties not under common control of the general partner—for example, family members the general partner does not “control,” or equity method investees over which the general partner has significant influence but not control. AcSEC is not convinced that the general partner and its related parties together truly “control” the partnership if that conclusion depends on the aggregation of related parties that are not under common control. As an alternative to the related party definition in the proposed EITF Issue and FSP (paragraphs 3 and 5, respectively), which refers to the definition of related parties in FAS 57, AcSEC recommends that the Board consider limiting the circumstances under which related party interests should be aggregated for purposes of applying the consolidation guidance in the proposed EITF Issue and FSP to those described in paragraph 19(c) of the proposed EITF Issue (which is similar to item 3 under “Factors to Consider” in EITF Issue No. 96-16).

7. In two places in paragraph 7 of the proposed FSP, replace “a company” with “an entity”.

8. Paragraph 8 of the proposed FSP states that the effect of initially applying the guidance should be accounted for as a cumulative effect adjustment under paragraph 19 of APB Opinion No. 20, *Accounting Changes*. Paragraph 9 then states that, generally, a change in accounting for a general partner’s interest in a partnership from the equity method to consolidation or vice versa would *not* result in a cumulative effect adjustment. AcSEC recommends that the order of paragraphs 8 and 9 be reversed, and that the new paragraph 9 start with a phrase such as “In certain circumstances” in order to provide guidance on cumulative effect adjustments only after the reader understands that the circumstances in which such adjustments will be needed are relatively uncommon.

9. In footnote 3 to paragraph 9 of the proposed FSP, replace “see” with “pursuant to”.

Proposed EITF Issue No. 04-5

10. The Notice to Recipients of the draft EITF abstract requested comments with respect to whether the guidance in the proposed EITF Issue should be consistent with that in EITF Issue No. 96-16. AcSEC believes that the guidance in the proposed EITF Issue on whether certain rights constitute substantive participating rights should be consistent with that in EITF Issue No. 96-16.

11. Although SOP 78-9, read literally, applies only to real estate ventures, the wording of the second to last sentence of paragraph 1 of the proposed EITF Issue makes it sound as if SOP 78-9 is already applicable to all partnerships.

12. The issue and scope section of the proposed EITF Issue is specific to a sole general partner, whereas SOP 78-9 recognizes that situations may exist in which a partnership exists with multiple parties, which may be related or unrelated parties, designated as general partner. It is unclear why the provisions of EITF 04-5 would be limited only to sole general partners or, stated differently, why the framework proposed in EITF 04-5 should not be applied to a partnership with multiple general partners. AcSEC recommends that the Task Force, staff, and Board consider defining the scope of the consolidation guidance in both the proposed EITF Issue and the proposed FSP to focus on whether the party making the evaluation owns “substantially all” of the general partner interests. Also, AcSEC recommends that the Task Force clarify whether the reference in paragraph 3 of the proposed EITF Issue to related parties of the investor includes or excludes related parties that hold only limited partner interests.

13. In footnote 4 to paragraph 5 of the proposed EITF Issue, replace the words “shall have” with “has” to be consistent with EITF wording protocol.

14. Footnote 5 to paragraph 5 of the proposed EITF Issue states that if the limited partners can exercise their kick-out rights only when the limited partnership does not achieve certain specified performance targets, the kick-out rights may overcome the presumption of control. If such performance targets are set so low that it is very likely the general partner will achieve the performance targets, the kick-out rights would appear to have no substance because it is unlikely they will be able to be exercised. AcSEC therefore believes it may be helpful to insert the word “reasonable” before “specified” in the footnote.

15. Paragraph 6(a) of the proposed EITF Issue provides one of the required characteristics of substantive kick-out rights. The reference to a vote by a single limited partner and its related parties would benefit from further clarification. AcSEC believes it would be helpful if an example was provided to illustrate that requirement. Additionally, AcSEC believes examples to illustrate the application of paragraph 6(b) [for example, the concept of “inadequate compensation” in item (3)] would be helpful.

16. In paragraph 6(a) of the proposed EITF Issue, insert “either (1)” after “exercised by” and insert “(2)” after “general partner or”.

17. In paragraph 6(a) of the proposed EITF Issue, clarify whether the reference to voting interests held by parties other than the sole general partner refers only to limited partner voting interests. This clarification is necessary to reconcile the requirement of paragraph 6(a) to the requirement of paragraph 19(b)(1). The Task Force may need to further adjust the wording assuming that the guidance will not apply only to situations involving a sole general partner.

18. AcSEC observes duplication in the listing of barriers to kick-out rights in paragraphs 6(b) and 19(b)(2) of the proposed EITF Issue and believes that consideration should be given to restructuring the document to eliminate that duplication.

19. Paragraph 7 of the proposed EITF Issue states, “the limited partners’ unilateral right to withdraw from the partnership in whole or in part without incurring significant economic penalty (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).” It would be helpful to clarify whether, in this context, a dissolution or liquidation requirement for the entire limited partnership upon withdrawal of the limited partners from the partnership *would* be considered a kick-out right. It would also be helpful for the paragraph to clarify whether a dissolution or liquidation right is required to be a contractual right to be considered a kick-out right. If, for example, the limited partners’ interest collectively is large, their withdrawal might effectively require dissolution or liquidation of the entire limited partnership to raise the necessary cash, even though the partnership is not contractually required to dissolve or liquidate.

20. Paragraph 12 of the proposed EITF Issue indicates that “ordinary course of business” does not include self-dealing transactions with the sole general partner. It is unclear whether activities such as asset management on behalf of the partnership, which may involve self-dealing with the sole general partner, are thereby excluded from the ordinary course of business. A similar question on what constitutes “self-dealing” arises in paragraph 14(b).

21. AcSEC believes that the proposed EITF Issue would benefit from including an example on whether “opt-out” rights for new endeavors would be considered protective or participating. For example, in some partnerships if a general partner begins the process of acquiring a particular startup company and the acquisition would require additional capital from the limited partners in order for it to take place, the limited partners may have the right to elect whether or not to participate. Should that right be considered a substantive participating right, and would the answer depend on whether or not the partnership makes such acquisitions infrequently versus frequently (i.e., in the ordinary course of business)?

22. AcSEC believes it would be helpful if paragraph 16 of the proposed EITF Issue clarified whether actions (a) and (b) should be considered on a standalone basis (one or the other would overcome the presumption of general partner control) or in combination (both together are necessary to overcome the presumption of general partner control).

23. Under EITF Issue No. 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” (“Issue 97-2”), a controlling financial interest exists if, for a requisite period of time, the physician practice management entity (PPM) has “control” over the physician practice and has a “financial interest” in the physician practice that meets six requirements listed in the consensus. Among those requirements are that the PPM have a “significant financial interest” in the physician practice. Paragraph 19(a) of the proposed EITF Issue discusses the relationship between the size of the general partner’s economic interest in the limited partnership and the level of skepticism about the presumed ability of the general partner to control the partnership.

AcSEC is unclear whether the proposed EITF Issue's guidance on economic or financial interest is intended to achieve the same objective as or a different objective from the Issue 97-2 guidance in terms of the significance that a financial interest should have in order for control to be present and thus for consolidation to take place. AcSEC believes it would be helpful for the Task Force to reconcile the guidance on level of skepticism (both in the proposed EITF Issue and in EITF Issue No. 96-16) to the "controlling financial interest" requirement discussed in ARB 51, *Consolidated Financial Statements*, FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*, and Issue 1 of Issue 97-2. In addition, AcSEC believes that any reconciliation provided between the two sets of guidance would benefit from one or more examples illustrating the distinction.

24. The second sentence in paragraph 19(a) of the proposed EITF Issue would be clearer if it stated that as the general partner's interest increases and the limited partners' interest decreases, the rights of the limited partners are presumptively more likely to be protective rights.

25. Paragraph 19(b)(1) of the proposed EITF Issue discusses one of the factors to consider in determining whether limited partners' rights that appear to be participating are substantive. Under the second sentence of that paragraph, if the exercise of the limited partners' voting rights is dependent on the total votes of both the limited partners and the sole general partner, then the voting interest held by the sole general partner must be considered to determine if the limited partners' rights related to voting are substantive. AcSEC is unclear how, if the exercise of the limited partners' voting rights requires the general partner's vote and effectively allows the general partner to block limited partner votes, the participating rights could be considered substantive. AcSEC recommends also that examples be provided to illustrate the second sentence of paragraph 19(b)(1).

26. Paragraph 21 of the proposed EITF Issue requires a reassessment of the limited partners' rights by the general partner under certain circumstances. Assume that the presumption of control has been overcome by the existence of certain limited partner rights, and the general partner has been applying the equity method to its investment in the partnership. Assume further that the general partner has not recorded losses under the equity method that it would have recorded had it consolidated the limited partnership. AcSEC believes the Task Force should address whether, if the limited partners' participating rights expire, the general partner should reflect the unrecorded losses in the prior years.

27. Paragraph 25 of the proposed EITF Issue states that a change from the equity method to consolidation could result in a cumulative effect adjustment under Transition Method A if losses that would not have been recognized under the equity method are required to be recognized in consolidation or vice versa, and that other items that would have been accounted for differently in prior financial statements if the proposed EITF Issue's guidance had been applied should not be adjusted. AcSEC believes the Task Force should consider, if it has not already done so, whether another potential source of

difference between the equity method and consolidation (at least for real estate partnerships) may be the allocation of profits and losses under paragraph 25 of SOP 78-9.

28. In footnote 7 to paragraph 25, replace “refer” with “pursuant”.

29. AcSEC believes that the effective dates of the proposed FSP and EITF Issue should be the same.

30. AcSEC observes that Examples 4 and 5 in Exhibit 04-5A of the proposed EITF Issue begin with a question as to whether limited partner rights are protective or participating but end with a conclusion relating to whether the rights are substantive. AcSEC recommends that the words “would not be substantive” and “are not substantive” at the end of Examples 4 and 5, respectively, be replaced with the words “would be protective not participating” and “are protective not participating,” respectively.

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We appreciate the opportunity to comment on the proposed FSP and EITF issue. Representatives of AcSEC would be pleased to discuss our comments with the Board members or staff.

Sincerely,

Mark Bielstein, Chair
Accounting Standards Executive Committee

Roy Rendino, Chair
FSP SOP 78-9-a Task Force