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February 18, 2005

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Financial Accounting Standards Board
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File Reference Nos. EITF 0405 and SOP78-9-a

Dear Mr. Smith:

We appreciate the opportunity to comment on the exposure drafts of the proposed 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 proposed FASB Staff Position No. 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.'"

Overall Comments

We agree with the EITF's conclusion that the consolidation evaluation by a general partner of a limited partnership should be the same regardless of the type of partnership (i.e., real estate or non-real estate). However, we do not agree with the EITF's proposed model for determining whether the general partner controls the limited partnership.

We believe that the proposed model would require general partners to consolidate certain limited partnerships that general partners do not control. Under the proposed model, general partners may be required to consolidate a limited partnership even though the limited partners have the right to remove the general partner. We question the ability of the general partner to control the partnership when the limited partners have the right to remove the general partner, even when the vote of the limited partners may require more than a simple majority to remove the general partner. The proposed model also would require consolidation of certain limited partnerships even when the general partner does not have the right to sell the assets of the partnership, acquire additional assets in the partnership, or borrow money in the partnership without the approval of the limited

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partners. We believe it would be inappropriate to consolidate the assets and liabilities of the partnership in the general partner's financial statements in situations when the general partner's ability to take actions with respect to such assets and liabilities is subject to such significant restrictions due to the rights of the limited partners.

The proposed model incorporates certain guidance from FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities* (FIN 46R). We do not believe it is appropriate to apply the simple-majority kick-out right requirement of FIN 46R to determine whether the general partner controls the partnership because that guidance is based on an effective control concept. Rather, we believe that a legal or unilateral control concept should be applied to determine whether the general partner controls the partnership. We believe that the Board should address the overall consolidation model for non-variable interest entities rather than apply certain provisions of FIN 46R to such entities.

While we understand the circumstances that led to the EITF's efforts towards the development of a new model to determine when a sole general partner should consolidate a limited partnership, we believe that the EITF and the FASB staff should not proceed with the guidance as proposed. We believe that the EITF should continue its deliberations on this Issue by focusing its efforts on determining whether certain rights of limited partners, such as withdrawal rights, constitute important rights as contemplated under the existing provisions of SOP 78-9.

The following paragraphs more fully describe our concerns about the proposed model and provide additional comments on the proposed EITF Issue and proposed FSP.

Expansion of the effective control concept

U.S. GAAP consolidation guidance is based upon the principle that enterprises should consolidate entities in which they have a "controlling financial interest." ARB No. 51, *Consolidated Financial Statements*, and FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*, equate control with the ownership of a majority voting interest, which is a notion of legal or unilateral control. FIN 46R relies upon an evaluation of economic risks and rewards to identify controlling financial interests in entities that either are not controllable through voting interests or for which the equity investors do not bear the residual economic risks and rewards. The underlying premise of FIN 46R is that the party that absorbs a majority of the economic risks and rewards of a variable interest entity will most likely control the entity, representing a form of imputed or effective control.

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The proposed EITF Issue and FSP extend the applicability of the effective control concept by potentially requiring a general partner to consolidate a limited partnership over which it does not have legal or unilateral control. Under the guidance in the proposed EITF Issue and FSP, one of the ways in which the presumption of control by the general partner may be overcome is for the limited partners to have substantive kick-out rights to remove the general partner. A provision requiring a vote of more than a simple majority (for example, two-thirds) of the limited partners in order to exercise such kick-out rights would not be considered substantive under the proposed guidance. We believe that proposed guidance represents an effective control concept because a general partner who does not have unilateral control (because it could be removed by the limited partners) would be required to consolidate certain partnerships if the kick-out rights required more than a simple majority vote of the limited partners. That approach is similar to an effective control approach that would require a shareholder with forty percent of a corporation's voting stock to consolidate the corporation because the corporation's other shareholders own only small amounts of its voting stock and would have difficulty blocking the actions of the forty percent shareholder. That effective control approach is not consistent with the legal or unilateral control model of ARB 51 and FAS 94 under which consolidation is required only when a shareholder has a controlling financial interest in another entity and the minority shareholders are unable to block significant actions of the majority shareholder. Under a legal or unilateral control basis of consolidation, the general partner does *not* control the partnership if the unaffiliated investors in the limited partnership have the right to remove the general partner. We believe that approach is consistent with the existing guidance in ARB 51 and FAS 94, and the application of that guidance to shareholders' interests in corporations as described above, and the "important rights" concept currently in SOP 78-9.

The extension of the effective control concept will create numerous implementation issues that have not received sufficient evaluation to date. Respondents to the Board's February 1999 Exposure Draft (the 1999 ED), *Consolidated Financial Statements: Purpose and Policy*, identified numerous concerns about the operability of an effective control consolidation model and the Board has not yet resolved those issues. As such, we do not believe that the effective control approach to consolidation should be extended until the Board has fully studied the application difficulties expressed in the responses to the 1999 ED and developed general principles on consolidation for non-variable-interest entities, including principles underlying a legal control versus effective control basis for consolidation.

In addition to our concern about the issuance of new consolidation guidance prior to development of an overall consolidation model, we are concerned about modifying

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partnership consolidation guidance without any related attempts to develop an overall model for partnership accounting. Accordingly, we believe that the Board should consider the accounting for general partnerships, limited partnerships, limited liability companies, and similar structures that use specific ownership accounts, including the associated consolidation issues, as a single, comprehensive project.

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. If the Board moves forward with the proposed EITF Issue and FSP, we recommend that the Board consider the broader applicability of SOP 78-9's principles to other industries.

Expansion of selected requirements of FIN 46R

We do not agree with the application of selected provisions of FIN 46R beyond variable interest entities. Specifically, the guidance in paragraph B20(a) of FIN 46R regarding kick-out rights is included in the proposed EITF Issue and FSP for purposes of evaluating whether the general partner controls the partnership. However, as previously noted, FIN 46R was intended to address entities that either are not controllable through voting interests or for which the equity investors do not bear the residual economic risks and rewards. Limited partnerships within the scope of the proposed EITF Issue and FSP do not meet either of those criteria and paragraph 3 of the proposed EITF Issue notes that the scope of this Issue does not include variable interest entities.

The guidance in paragraph B20 of FIN 46R is utilized in the proposed EITF Issue and FSP for a purpose other than what it was specifically designed for in FIN 46R. The guidance in paragraph B20 of FIN 46R represents only one aspect of the evaluation of whether certain service providers have a *variable interest* in a variable interest entity. It was not specifically designed to establish whether those service providers *control* the variable interest entity. Ironically, in many circumstances (probably most circumstances), a general partner that would be required to consolidate a limited partnership under the guidance in the proposed EITF Issue and FSP would not be the primary beneficiary if that same limited partnership were evaluated as a variable interest entity.

Accordingly, we do not believe that selected provisions of FIN 46R should be applied to voting interest entities without appropriate Board consideration of the overall consolidation model for such entities. However, if the EITF moves forward with the proposed model, we believe the EITF should reconcile and provide explanation for the differing consolidation outcomes as noted above that would arise from the application of the FIN 46R consolidation model versus that in the proposed EITF Issue or FSP to any given limited partnership.

Need for refinement of the Issue 96-16 model

Because the general partner's investment in many limited partnerships is nominal, we believe that Issue 96-16 is not particularly well suited for application to limited partnerships without some modifications. Issue 96-16 contemplates corporate-form entities. That issue indicates that "in some instances, the powers of a shareholder with a majority voting interest to control the operations or assets of the investee are restricted in certain respects by approval or veto rights granted to the minority shareholder." The participating rights advanced in Issue 96-16 were deemed to undermine control of the majority owner, who typically would be expected to make a significant investment to obtain the majority interest. Under EITF Issue 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," 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 acknowledges that "although the general partner is presumed to control the limited partnership, the level of skepticism about such ability should increase as the sole general partner's economic interest in the limited partnership decreases." We agree that the level of skepticism about a general partner's ability to control should increase as its economic interest in the partnership decreases. However, we believe that provision of the guidance should be included as part of the initial determination of whether the general partner controls the limited partnership rather than part of the guidance on determining whether participating rights are substantive and that the EITF Issue should provide sufficient explanation of the implications of the proposed guidance in relation to Issue 97-2.

Another aspect of Issue 96-16 that requires refinement, particularly in the context of real estate partnerships, is the guidance regarding rights to block acquisitions and dispositions of assets that represent more than 20 percent of the fair value of the investee's total assets. Consistent with the guidance in Issue 96-16, 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. We do not believe there should be a 20 percent bright line threshold for purposes of this evaluation. Consider a real estate limited partnership that owns two properties with similar fair values that the partnership intends to operate and then sell. The sales of those assets would appear to be in the "ordinary course of business" (as that phrase is used in paragraph 16(b) of the proposed EITF Issue) in that circumstance and, therefore, the right to approve those sales should be considered a participating right rather than a protective right (as it would be under the proposed EITF Issue). This issue becomes even more pronounced when the partnership's only major asset is a single property.

In particular, we question consolidation in situations in which both (a) the general partner has a nominal economic interest and (b) the limited partners have rights that limit the general partner's ability to exercise unilateral control over the limited partnership and the assets of the limited partnership.

1. We believe that the effective dates of the proposed FSP and EITF Issue should be the same.
2. The proposed FSP and EITF Issue both contain guidance under which the presumption of control may apply to a related party group (refer to paragraph 5 of the proposed FSP and paragraph 3 of the proposed EITF Issue). We believe that parties not under common control should be excluded from the definition of "related parties," for purposes of the consolidation analysis required by the proposed FSP and EITF Issue. We believe that the general partner and its related parties do not "control" the partnership if that conclusion depends on the aggregation of related parties that are not under common control. We believe that view is consistent with current practice for determining whether an entity has indirect control over another entity under ARB 51. In addition, no guidance is provided in either the proposed FSP or EITF Issue regarding how to determine which of the related parties should consolidate the partnership in the event that the presumption of control is not overcome.
3. 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*. However, paragraph 9 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. We recommend that the Board consider reversing the order of paragraphs 8 and 9, and that the new paragraph 9 start with a phrase such as “In those circumstances in which the change in accounting from equity method to consolidation or vice versa results in an adjustment to previously reported equity or net income.”

4. 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, including an example to illustrate that requirement. Additionally, examples to illustrate the application of paragraph 6(b) [for example, the concept of “inadequate compensation” in item (3)] would be helpful.
5. Under the guidance in paragraph 7 of the proposed EITF Issue the limited partners’ unilateral right to withdraw from the partnership in whole or in part would not overcome the presumption that the sole general partner controls the limited partnership if that right does not require dissolution or liquidation of the entire limited partnership (that is, the withdrawal right in that circumstance 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 that is implicit rather than contractual may be considered a kick-out right. If, for example, the limited partners’ interest collectively is large, their withdrawal may implicitly 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.
6. The proposed EITF Issue should address whether individual partner “opt-out” rights for new investments or acquisitions would be considered protective or participating. For example, in some investment partnerships, the limited partners may have the right to elect whether or not to participate in the acquisition of a new investment that would require additional capital from the limited partners. We believe an example or other guidance should be provided to indicate whether that right would be considered a substantive participating right, and if the answer would depend on whether or not the partnership makes such acquisitions infrequently versus frequently (i.e., in the ordinary course of business).
7. Paragraph 21 of the proposed EITF Issue requires a reassessment of the limited partners’ rights by the general partner under certain circumstances. We presume that the Board intends for a change from the equity method of accounting to

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consolidation or vice versa to be accounted for similar to other situations in which control is acquired or given up, but it would be helpful for the proposed EITF Issue to clarify this.

8. If the EITF and FASB staff proceed with the proposed model, we believe the EITF should consider potential disclosure requirements that would provide information to financial statement users about restrictions of the ability of the consolidated entity to take certain actions such as sales, of assets presented on the balance sheet.

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If you have questions about our comments or wish to discuss any of the matters addressed herein, please contact Mark Bielstein at (212) 909-5419 or Kimber Bascom at (212) 909-5664.

Very truly yours,

KPMG LLP