

BNKJ Real Estate Roundtable

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EIFT Issue No. 04-5

Investor Accounting and Potential Consolidation of Partnerships/LLCs

- Survey or overview of various consolidation and potential consolidation guidance
- EITF 04-5
 - Historical contexts
 - Analysis and discussion of provisions

Consolidation Guidance

- **Prior guidance - Corporate based ownership**
 - ARB 51/FAS 94
 - EITF 96-16
- **Prior guidance - non-corporate based ownership**
 - SOP 78-9
- **New guidance:**
 - FIN 46 and 46R – variable interest entities, corporate and non-corporate
 - EITF 04-05 - non-corporate entities, reconciled prior guidance in EITF 96-16 and SOP 78-9

Prior Consolidation Guidance

ARB 51 (1959) and FAS 94 (1987)

- “Corporate” ownership structure based
- Presumption that a majority ownership (i.e. > 50%) controls and therefore should consolidate
- Conceptual weaknesses of bright line 50% test:
 - When the basis of investee governance and/or control is not ownership % based
 - With more complex non-corporate structures – governance and economic based issues

Prior Consolidation Guidance

EITF Issue 96-16 - Majority investor accounting when minority owners have certain “participating rights”

- Participating vs. protective rights concepts
- Not applicable to non-corporate entities
- Minority owners “effectively participate in certain significant financial and operating decisions...in the normal course of business”.
- Majority therefore does not control – won’t consolidate
- 20% “Bright-Line” test-asset acquisition/dispo.

Prior Consolidation Guidance

“Non-corporate” entity guidance

- **SOP 78-9 - written for real estate JV's**
- “control” is not majority based
 - “important decisions” concept - not well defined
- has been applied to non real estate scenarios
- joint control, then who consolidates?

Prior Consolidation Guidance

“Non-corporate” entity guidance

- EITF 98-6 - sole GP in an LP and LP's have certain approval or veto rights
- Analogous to EITF 96-16 for corporate entities
- **No consensus**, working group formed to reconcile
 - EITF 96-16 “substantive participating rights” for corporate minority
 - SOP 78-9 “important decisions” for non-corporate investments

New Consolidation Guidance

- **EITF Issue 04-05 Consensus - General Partner Consolidation of LP's**
 - FASB just ratified this consensus on June 29, 2005
 - Reconciles EITF 96-16 (corporate) and SOP 78-9 (non-corporate) differences on governance/control
- **FIN 46 and 46R (revised Dec. 2003) - Variable Interest Entities**
 - Based on economic reality in complex structures
 - who has majority economic upside/downside?
 - Interpretation to ARB 51
 - Direct outcome of Enron's "abusive" techniques

How to consider consolidation questions/issues

- **Always start with FIN 46R**
 - VIE concept is an “overriding” application
 - VIE consolidation and “traditional” consolidation are mutually exclusive-if a VIE, then stop at FIN 46R

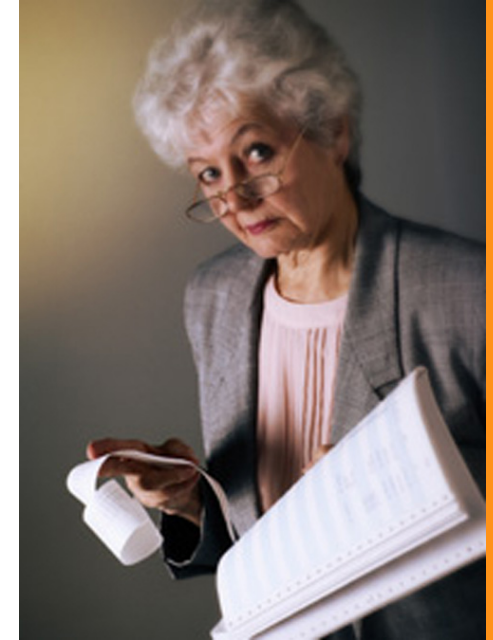
- **If you do not have a VIE under FIN 46R**
 - only then go on to “traditional” consolidation accounting guidance
 - ARB 51/FAS 94 generally;
 - EITF 96-16, SOP 78-9, (both as amended) and 04-05 for specific cases and issues of control.

When Should Consolidation Issues Be Considered?

- **At formation of an entity**
- **After formation when:**
 - Ownership changes
 - Governance provisions are modified
 - Other significant events – FIN 46R non-equity
 - Or, when formerly unrelated owners become related parties

EITF Issue No. 04-05

Investor's Accounting for an Investment in a Limited Partnership or Similar Entity



Modifications Required

- **SOP 78-9’s “important decisions” concept for non-corporate entities and**
- **EITF Issue 96-16’s “participating rights” concept for corporate entities**
- **Reconciled as a result of EITF 04-05 through**
 - FSP SOP 78-9-1
 - Amended EITF Issue 96-16, removed 20% “bright-line” test (for corp/LP consistency)
 - Both now consistent with EITF 04-05

Applicable To

Limited Partnerships or similar entities

- **LLC with non-corporate ownership accounts/governance structure**
 - manager viewed as the GP
- **General Partnership or Multiple GP LP's**
 - if one of the GPs has control

Not Applicable To LLCs

- **Corporate ownership/governance structure – C or S Corp, LLC depending on governance structure**
- **Non-owner/non-member manager**
 - where no other member controls the LLC or the non-owner/manager

Issues Addressed

- **Does the General Partner have control?**
 - And should therefore consolidate
- **What levels/types of LP control does it take**
 - for the GP to not have control/consolidate?
- **GP's % ownership**
 - Does consolidation answer matter how large or small?

Control Concepts

That indicate GP does NOT have unilateral control

- LP's ability to dissolve entity or remove GP
- LP's participation in management

Implementation

- **Effective dates Issue 04-05 and FSP SOP 78-9-1**
 - New LP's or changes to existing LPs – June 29, 2005 for all investees
 - All others – no later than fiscal years beginning after December 15, 2005 (2006 for calendar year entities)

- **Pre-existing investments - change in accounting principle, use either transition method**
 - Method A – cumulative effect adjustment
 - do not restate prior years, only previous interim periods in year of adoption
 - Method B – restate all prior periods

Presumption

The GP has control of an LP - to overcome the presumption LP's must have either

- the substantive ability to either
 - dissolve the LP or
 - otherwise remove the GP
 - (“kick-out rights”) without having to show cause, or
- Substantive participation rights (taken from 96-16) – facts and circumstances, judgemental.

Liquidation Or Kick Out Rights

- **By a single LP or by no more than simple majority vote**
 - Only the unrelated LP interests
 - Excludes LP's who are related to the GP
- **“Substantive” - No financial or operational barriers to exercise these rights, such as**
 - Widely syndicated deals, lack of mechanism
 - No suitable replacement GP or compensation

Liquidation Or Kick Out Rights

Withdrawal or redemption rights of the LP's

- **Not usually equivalent to dissolution rights**
- **Certain exceptions**
 - Contractual legal dissolution required (as opposed to a tax dissolution)
 - Economic reality – redemption requires sale of substantially all assets

Substantive Participating Rights

Rights that allow the LP's to

- Effectively participate
- In significant decisions
- Expected in the ordinary course of business

Substantive Participating Rights

Protective Rights?

- Substantive participating rights are protective in nature
- But, not all protective rights provide substantive participation

Substantive Participating Rights

Always

- **Selecting, terminating and setting management's compensation**
- **Establishing operating and capital decisions/budgets in the ordinary course of business**
 - Block asset acquisitions/dispositions, no 20% de minimus exception

Substantive Participating Rights

Compensation and operating/capital decision – need both or individually?

- Can be individual
- Need all substantive actions of either one
 - to have effective participation in day-to-day decision making

Substantive Participating Rights

Not all inclusive

- **Matter of judgment**
 - Protective or substantive participating?
 - Examples in EIFT Appendix
- **Facts and circumstances**
 - LPs related to GP
 - Block vs. implement budgets

Sole LP with Control?

- **GP does not control,**
 - does not consolidate under EITF 04-05,
- **Should the sole LP consolidate?**
 - Yes, if they can cause liquidation or “kick out”
 - No, if just substantive participation rights (but not absolute control)

Application

- **When first a GP or LP**
- **Annually thereafter to determine if changes to:**
 - Terms or exercise rights of GP's or LP's
 - Ownership of LP interests
 - Number of LP interests