LIMITED LIABILITY ENTITIES
CONSIDERING SOME ACCOUNTING ISSUES

Reporting entities frequently are formed as limited liability entities, particularly limited liability companies [LLCs] and limited liability partnerships, hereinafter referred to collectively as LLCs. While much of the accounting authoritative technical literature used in financial reporting by LLCs is the same literature used by other types of reporting entities, there is some literature including requirements uniquely-applicable in financial reporting by LLCs. The accounting literature that particularly relates to these type entities is found in the FASB Accounting Standards Codification [FASB ASC] Topic 272, entitled Limited Liability Entities.

Practice Note: Much of the guidance in FASB ASC 272 is brought forward from AICPA Practice Bulletin 14, entitled Accounting and Reporting by Limited Liability Companies and Limited Liability Partnerships. Practice Bulletin 14 was released in April 1995 by the Accounting Standards Executive Committee [AcSEC], where AcSEC now is known as the Financial Reporting Executive Committee [FinREC]. Practice Bulletins historically were utilized in efforts to disseminate views of AcSEC, and now FinREC, related to issues that had not been considered by the FASB or, in the governmental arena, the GASB. However, at this point, the FASB has considered the guidance in the legacy document Practice Bulletin 14, so that the authoritative accounting requirements reside in the FASB ASC.

LLCs have characteristics of both corporations and partnerships, but these type entities also are dissimilar in many respects. LLCs are formed in accordance with laws of the various jurisdictions under which the entities are organized. Given that laws in this arena are not uniform, characteristics of LLCs may likely vary from jurisdiction to jurisdiction. With that said, LLCs generally have the following characteristics:

- They are unincorporated associations of two or more persons.
- Their members have limited personal liability for the obligations or debts of the entities.
- They are classified as partnerships for federal income tax purposes.
Practice Note: The above-noted characteristics are not intended to be representative of characteristics in the statutes of each jurisdiction. As such, preparers of LLC financial statements, and practitioners performing attest engagements on those statements, need to be cognizant of legislation enacted in jurisdictions where the LLCs are organized.

As clearly-delineated in FASB ASC 272-10-06, in order for LLCs to be classified as partnerships for federal income tax purposes, they must lack at least two of the following corporate characteristics:

- Limited liability.
- Free transferability of interest.
- Centralized management.
- Continuity of life.

Practice Note: It should be noted that many jurisdictions have adopted similar requirements in order for LLCs to be classified as partnerships for state income or franchise tax purposes. However, certain jurisdictions have enacted LLC legislation that includes income tax requirements. Additionally, when LLCs operate in jurisdictions where either LLC legislation has not been enacted or where LLCs are subject to income taxation, they may be subject to income tax requirements on income derived from operations in those jurisdictions.

Understanding Some General LLC Characteristics

Owners of LLCs are referred to as members. Like corporations, members of LLCs are not personally liable for liabilities of the entities. With that said, paralleling partnerships, LLC members, rather than the entities themselves, are taxed on respective shares of LLC earnings.

Dissimilar to limited partnerships, it generally is not necessary for one owner [e.g., the general partner in a limited partnership] to be liable for the liabilities of the LLCs. Also, in contrast to limited partnerships where general partners manage those entities, or corporations where boards of directors and their committees control operations, members may participate in management of LLCs. Even with that participation, members generally do not forfeit the protection from general liability that results from the structure of LLCs.

General partners of limited partnerships have control but also have unlimited liability, where limited partners have limited liability paralleling the liability structure associated with LLC members. Also, all partners in general partnerships have unlimited liability. Paralleling partnership structures, financial interests in most LLCs may be assigned only with the
consent of all LLC members. And, as with partnerships, most LLCs are dissolved by death, bankruptcy, or withdrawal of a member.

*Practice Note:* Again as emphasis, since U.S. LLCs are formed in accordance with laws in jurisdictions where they are organized, and because those laws are not uniform, the characteristics of LLCs vary from jurisdiction to jurisdiction. As such, the characteristics discussed above that typically are associated with LLCs are not intended to be representative of characteristics in the statutes of each jurisdiction.

**Accounting at Formation of LLCs**

FASB ASC 272 does not provide any specific guidance related to how assets and liabilities should be recorded when LLCs are formed by combining entities under common control or by conversion from other types of entities. However, without including specific guidance in this area, FASB ASC 272-10-60-4 does include a reference to FASB ASC 805, entitled *Business Combinations,* for the appropriate guidance.

FASB ASC 805-50-16 provides guidance that is applicable to combinations between and among entities or businesses that are commonly controlled. The following are examples of those types of transactions:

- An entity charters a newly-formed entity and then transfers some or all of its net assets to that newly-chartered entity.
- A parent transfers the net assets of a wholly-owned subsidiary into the parent and liquidates the subsidiary; that transaction is a change in legal organization but not a change in the reporting entity.
- A parent transfers its controlling interest in several partially-owned subsidiaries to a new wholly-owned subsidiary; that transaction is a change in legal organization but not a change in the reporting entity.
- A parent exchanges its ownership interests or the net assets of a wholly-owned subsidiary for additional shares issued by a less-than-wholly-owned subsidiary of the parent, thereby increasing percentage ownership of the parent in the less-than-wholly-owned subsidiary but leaving all of the existing noncontrolling interest outstanding.
- A less-than-wholly-owned subsidiary of the parent issues its shares in exchange for its shares of another subsidiary previously-owned by the same parent, and the noncontrolling shareholders are not party to the exchange; that transaction is not a business combination from the perspective of the parent company.
- An LLC is formed by combining entities under common control.
- Two or more not-for-profit entities that are effectively controlled by the same board members transfer their net assets to a new entity,
dissolve the former entities, and appoint the same board members to the newly-combined entity.

Practice Note: As clearly-noted in FASB ASC 805-10-15-4(c), the general guidance related to business combinations in FASB ASC 805 is not applicable to combinations between and among businesses under common control. This would be the case as noted in the next-to-last bullet-point in the bullet-point listing above. In these circumstances, in accounting for transfers of assets exchanged between and among entities that are commonly controlled, the entity receiving the net assets initially recognizes assets and liabilities at the date of the transfer. Since these type transfers are between and among commonly controlled entities, the newly-formed LLCs, at their inception, would record assets and liabilities at amounts at which they were stated in the financial statements of the predecessor entities.

LLC Financial Statements

Using the guidance in FASB ASC 272-10-45-1, a complete set of LLC financial statements needs to include all of the following:

- A statement of financial position at the end of the reporting period.
- A statement of operations for the reporting period.
- A statement of cash flows for the reporting period.
- Accompanying notes to the financial statements.

Practice Note: In addition to the above-noted financial statements and note disclosures, LLCs need to present information related to changes in member equity for the reporting period. As with entities other than LLCs, this information may be presented as a separate financial statement, combined with the statement of operations, or disclosed in the notes to the financial statements. Additionally, LLC financial statement headings need to clearly-identify the fact that the financial statements are prepared for reporting entities that are LLCs. In the legacy document guidance developed by AcSEC, the guidance related to the financial statement headings indicated that this conclusion would be true even in jurisdictions where LLCs are not required by law to include the LLC designation in the entity name; the FASB did not bring forward that guidance in FASB ASC 272-10-45-2.

Statement of Financial Position Equity Section Presentation

Financial statements of LLCs are required, from a presentation perspective, to be similar to those of partnerships. As noted previously, since LLC owners are referred to as members, the equity section in statements of financial position is required to be titled members’ equity.
Where LLCs are formed so that more than one class of members exist, each having varying rights, preferences, and privileges, using the guidance in FASB ASC 272-10-45-3, LLCs are encouraged to report each class separately within the equity section. In circumstances where LLCs do not report amounts for each class separately within the equity section of statements of financial position, they are required to disclose those amounts in notes to the financial statements.

**Practice Note:** In reaching the initial conclusion here that was incorporated into Practice Bulletin 14, AcSEC explained the rationale in that, in corporate financial statements, amounts initially invested [capital stock] are kept separate from subsequent income and distribution amounts. In partnership financial statements, this type separation is not maintained. AcSEC stipulated the belief that this type separation also would not be needed in financial statements of LLCs. Fundamentally, AcSEC concluded that presentations in equity section of statements of financial position should be similar to the presentation used by partnerships rather than the presentation used by corporations.

Using the guidance in FASB ASC 272-10-45-4, even though LLC member liability may be limited, if the total balance of the members’ equity account or accounts falls below zero, LLCs are required to report the deficits in statements of financial position. AcSEC reached this deficit display conclusion in developing Practice Bulletin 14, and the FASB agrees with that conclusion so that it is incorporated into FASB ASC 272.

Using the guidance in FASB ASC 272-10-45-5, when LLCs record amounts due from members for capital contributions, those amounts are required to be presented as deductions from members’ equity. Presenting these amounts as assets is considered to be inappropriate except in very limited circumstances where there is substantial evidence of ability and intent to pay within a reasonable period of time. To that end, the guidance in FASB ASC 272 refers to the guidance associated with displaying receivables for issuance of equity in FASB ASC 505, entitled *Equity*.

**Practice Note:** In FASB ASC 505-10-45-2, the FASB has the conclusion that, when reporting entities receive notes, rather than cash, as contributions to equity, reporting the notes as assets generally is not appropriate, except in very limited circumstances where there is substantial evidence of ability and intent to pay within a reasonably short period of time. As such, the predominant practice is to offset these type notes against equity [i.e., showing the notes as contra-equity accounts] rather than as displaying these notes as assets. However, these type notes may be recorded as assets if they are collected in cash before the financial
statements are issued or available to be issued, as those notions are discussed in FASB ASC 855, entitled *Subsequent Events*.

Paralleling the guidance associated with comparative financial statements for reporting entities other than LLCs, the FASB clearly-stipulated that presentation of comparative statements for LLCs is encouraged, but not required. The overarching guidance in this regard is in FASB ASC Topic 205, entitled *Presentation of Financial Statements*.

In FASB ASC 205-10-45-1, the FASB holds to the long-term conclusion that presentation of comparative financial statements in annual and other reports serves to enhance the usefulness of the reports and brings out more clearly the nature and trends of current changes affecting reporting entities. Additionally, comparative financial statement presentations serve to emphasize the fact that statements for a series of periods are far more significant than those for a single period and that the accounts for one period are but an installment of what is essentially a continuous history.

*Practice Note:* The issue of comparative financial statements only being encouraged and not required by the FASB is one of the many issues that likely will change in the process of converging accounting principles generally accepted in the United States of America [U.S. GAAP] with International Financial Reporting Standards [IFRS]. In IFRS, comparative financial statements are required, and the leaning appears to be that the FASB ultimately will move in that direction as well.

When formation of LLCs results in new reporting entities, the guidance in FASB ASC 250, entitled *Accounting Changes and Error Corrections*, comes into play. There, particularly in FASB ASC 250-10-45-21, when an accounting change results in financial statements that are, in effect, the statements of a different reporting entity, the change is required to be applied retrospectively in financial statements for all periods presented to show financial information for the new reporting entity for those periods. Additionally, previously-issued interim financial information is required to be presented on a retrospective basis.

*Practice Note:* The exception to retrospective application relates to guidance found in FASB ASC 835, entitled *Interest*. In particular, using the guidance in FASB ASC 835-20 related to capitalized interest, the FASB reached the conclusion in FASB ASC 250 that interest cost previously-capitalized is not required to be changed when retrospectively applying the accounting change to financial statements of prior periods.

**Financial Statement Note Disclosures**
In circumstances where LLCs do not report the equity of each class of its members separately within the members’ equity section of statements of financial position, they are required to disclose those amounts in the notes to the financial statements. When LLCs maintain separate accounts for components of members’ equity [e.g., undistributed earnings, earnings available for withdrawal, or unallocated capital], disclosure of those components, either on the face of statements of financial position or in notes to the financial statements, is permitted.

When comparative financial statements are presented for LLCs, amounts shown for comparative purposes need to be comparable with those shown for the most recent reporting period; otherwise, any exceptions related to comparability need to be disclosed in the financial statement notes so that the comparative financial statements actually will be comparable. Situations may exist where financial statements for periods prior to the period of conversion are not comparable with those of the most recent period where financial statements are presented [e.g., if transactions such as spinoffs or other distributions of assets occurred prior to or as part of an LLC formation]. In these type circumstances, disclosures need to be robust so that comparative financial statements are not misleading.

LLCs should ensure that both of the following disclosures are included in notes to the financial statements:

- A description of any limitation associated with member liability.
- The different classes of member interests and respective rights, preferences, and privileges of each class; additionally, in circumstances where LLCs do not report separately amounts for each class in the equity section of statements of financial position, those amounts are required to be disclosed.

In circumstances where LLCs have finite lives, the dates associated with when they will cease to exist needs to be disclosed. As discussed previously, LLCs must lack at least two characteristics typically associated with corporate forms of entities, where one of those characteristics relates to continuity of life. If this is one of the characteristics LLCs lack, that fact needs to be disclosed since it may be of significant interest to users of financial statements entering into transactions with the LLCs. As an example, limitations as to life of LLCs would be significant information to lenders in negotiating long-term loan agreements.

Related to income taxes, while LLCs generally are classified as partnerships for federal income tax purposes and, as such, are exempt from taxes in that tax liabilities flow through to LLC members, the disclosure requirements in FASB ASC 740, entitled Income Taxes, needs to be followed. Additionally, the recognition and measurement provisions
within FASB ASC 740 might be applicable in certain circumstances where LLCs have income generated that is subject to income tax.

In circumstances where LLCs are not subject to any income taxes, complying with the FASB ASC 740 disclosure requirements poses no significant challenges. An illustrative disclosure might be as follows:

**Income Taxes**

The Company is organized as a limited liability company under the Alabama Limited Liability Company Act structured to be treated as a partnership for income tax purposes.

Items of income or loss are allocated to the members in accordance with their respective equity interest and reported on their individual federal and state income tax returns.

Effective January 1, 2009, the Company implemented the provisions in Financial Accounting Standards Board Accounting Standards Codification Topic 740, *Income Taxes*, which requires disclosure of the amounts of interest and penalties related to income taxes. For the year ended, and as of, December 31, 2011, the Company had no interest and penalties related to income taxes.

With few exceptions, the Company is no longer subject to U.S. federal, state, and local income tax examinations by tax authorities for years before 2008.

*Practice Note:* As a reminder, without regard to how reporting entities are formed, the disclosure of open tax years needs to be included in notes to the financial statements. In some cases, it appears that the FASB ASC 740 guidance in this area has been misunderstood in that, when reporting entities, without regard to whether they are LLCs, have no uncertain tax positions, the disclosure of open tax years sometimes inadvertently has been omitted from the financial statement notes.

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