

**Emerging Issues Task Force
Agenda Committee Report
April 13, 2007**

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**Emerging Issues Task Force Agenda Committee
Decisions on Proposed Issues**

1. Accounting for a Sunset Clause in a Software Licensing Arrangement

Background

Entities that purchase software products have become increasingly concerned with the practice of certain software vendors who decide to discontinue supporting a licensed product and "transfer" or "migrate" the same features and functionality of the currently licensed product to a new product. The new software product may or may not have additional features or increased functionality from that of the discontinued product, and in some cases, the new software product may be included within a suite of products where the discontinued product forms only one element of the new software product.

If an entity wants to continue receiving support from the software vendor on the discontinued product, it must pay an incremental license fee to upgrade to the new software product, even if it is not interested in acquiring any additional features or increased functionality that may be part of the new product. Many entities have come to consider such practices as a mechanism for software vendors to generate additional license fees for products that are substantially the same as the currently licensed products. Accordingly, entities that purchase software products often request the inclusion of certain provisions in the software licenses that are designed to protect them from such practices and help ensure that a vendor will continue to support and update licensed software programs. These provisions are commonly referred to as Sunset Clauses.

Regardless of an entity's motivation for inclusion of a Sunset Clause in a contractual arrangement, such clauses are generally structured to apply only to those entities that have an arrangement with a software vendor for postcontract customer support (PCS) that is in place at the time of the discontinuance of the currently licensed software product.

AICPA Statement of Position 97-2, *Software Revenue Recognition*, provides guidance on the recognition of revenue by a vendor for software licensing arrangements including PCS. Questions have arisen, however, on how a software vendor should consider Sunset Clauses in an initial software licensing arrangement for purposes of determining the recognition of revenue

pursuant to SOP 97-2. While the nature and terms of Sunset Clauses vary considerably, there appears to be consistency amongst preparers and their auditors on the application of SOP 97-2. Often times, if the Sunset Clause is only a right to receive a software product that has no more than a minimal difference in price, functionality, or features, it's the staff's understanding that entities have accounted for the Sunset Clause as an exchange right in accordance with paragraph 50 of SOP 97-2 and have ascribed no value to it or considered it to be a separate element in determining revenue recognition. For other types of Sunset Clauses, entities have interpreted them to be similar to an unspecified future upgrade, which should be accounted for as a component of PCS and recognized as revenue over the related post contract service period. These views and others are discussed in further detail below.

Accounting Issue and Alternatives

How a software vendor should apply SOP 97-2 to a software licensing arrangement that includes a Sunset Clause in determining revenue recognition.

View A: A software vendor should not consider the Sunset Clause as a separate element if the software vendor has no immediate plans to discontinue the currently licensed software product.

Proponents of View A believe that since the addition of a Sunset Clause in a contractual arrangement between a software vendor and its customer does not provide any additional rights to the customer or impose additional obligations to the vendor that are not already provided by the other terms included in the arrangement, a Sunset Clause should not be considered a separate element in determining revenue recognition pursuant to the guidance in SOP 97-2. Since the Sunset Clause is not considered to be a separate element, there is no accounting recognition at the outset of the arrangement, assuming the vendor has no immediate plans to discontinue the currently licensed software product when it enters into the arrangement. Proponents of View A believe that the Sunset Clause serves to ensure that the customer will not lose rights otherwise conveyed by the terms of the arrangement due to the future actions of the vendor. Proponents believe that the lack of recognition as a separate element (when the vendor has no immediate plans to discontinue the software product) best reflects the nature of a Sunset Clause as a negotiated protective right that becomes operative only if the software vendor undertakes an action that would otherwise be detrimental to a customer.

View B: A software vendor should recognize a Sunset Clause as a right provided to the customer to receive unspecified future updates or enhancements on a when-and-if available basis pursuant to the PCS agreement.

Proponents of View B believe that when a software vendor agrees to include a Sunset Clause in a contractual arrangement to provide PCS in conjunction with the sale of a software license and subsequent renewals of PCS, such rights should be accounted for as PCS, that is, as a separate element pursuant to the guidance of paragraphs 56-62 of SOP 97-2. Generally, the portion of the fee allocated to PCS from the overall licensing arrangement should be recognized as revenue ratably over the term of the PCS service period, since the PCS services are assumed to be provided ratably.

Proponents of this View observe that a customer loses the rights conveyed by a Sunset Clause if the PCS arrangement is not renewed, and that a customer is entitled only to the same features and functionality as are provided under the currently supported licensed product pursuant to such a clause. They believe that the intention of a customer in requesting a Sunset Clause is not to receive a guarantee or commitment of the receipt of any future features, functionality, or product. Instead, the intention is to get the software vendor to commit that what the customer has purchased will remain available and will be supported and supplemented by upgrades and enhancements (on a when-and-if-available basis) so long as the software vendor is continuing to sell the licensed product.

Although opponents to this view acknowledge that Sunset Clauses are generally structured to apply only to those customers who have PCS arrangements that are current at the time of the discontinuance, they believe that it would be inappropriate to account for Sunset Clauses under PCS. They believe that the intent of a Sunset Clause is to provide customers who have licensed a certain software product with the right to receive an equivalent software product if the vendor decides to cease supporting the licensed product so long as the software vendor continues to sell the licensed product in its broader sense. Accordingly, opponents believe that such clauses are broader than a right to receive upgrades or enhancements to the currently licensed product, and are thus greater than the rights contemplated by the definition of PCS in SOP 97-2. Instead, opponents believe that Sunset Clauses should be accounted for in accordance with one of the views below.

View C: A software vendor should account for a Sunset Clause as an exchange right.

Proponents of View C believe that a Sunset Clause that limits the replacement software product that will be provided to a customer if the software vendor discontinues support of the currently licensed product to those products that have no more than a minimal difference in price, functionality, or features, may be accounted for as an exchange right in accordance with paragraph 50 of SOP 97-2. As such the exchange right would have no value ascribed to it and would not be considered a separate element in determining revenue recognition. Proponents of View C believe that the intent of a Sunset Clause is to provide customers who have licensed a certain software product with an equivalent software product (that is, one that does not differ significantly in terms of price, functionality, and features) when-and-if the vendor decides to cease supporting the currently licensed product.

Opponents of View C counter, however, that a software vendor cannot make the determination that the replacement software has a minimal difference in price, functionality, and features when compared to the discontinued product until that comparable product exists. Opponents therefore do not believe that a Sunset Clause can be considered an exchange right but, rather, should be considered a right of return.

View D: A software vendor should account for a Sunset Clause as a right of return.

Proponents of View D believe that if a Sunset Clause cannot be considered a right to exchange the currently licensed product for a product having no more than minimal differences in price, functionality, or features, the right should be accounted for as the right to return the software for other software that is dissimilar. Paragraph 51 of SOP 97-2 states that "exchanges by users of software products for dissimilar software products or for similar software products with more than minimal differences in price, functionality, or features are considered returns," and that such return rights should be accounted for in conformity with FASB Statement No. 48, *Revenue Recognition When Right-of-Return Exists*.

Paragraph 6 of Statement 48 states, in part, that:

...revenue ... shall be recognized ... only if *all* of the following conditions are met:

- a. The seller's price to the buyer is substantially fixed or determinable at the date of sale.
- b. The buyer has paid the seller, or the buyer is obligated to pay the seller and the obligation is not contingent on resale of the product.
- c. The buyer's obligation to the seller would not be changed in the event of theft or physical destruction or damage of the product.
- d. The buyer acquiring the product for resale has economic substance apart from that provided by the seller.
- e. The seller does not have significant obligations for future performance to directly bring about resale of the product by the buyer.
- f. The amount of future returns can be reasonably estimated.

Sales revenue and cost of sales that are not recognized at time of sale because the foregoing conditions are not met shall be recognized either when the return privilege has substantially expired or if those conditions subsequently are met, whichever occurs first. [Footnote references omitted.]

Proponents point out the difficulty in determining the amount of future returns, which will often require the deferral of revenue until the PCS period has lapsed (or the Sunset Clause is no longer valid).

Other proponents believe that for a product that has been discontinued, the lack of ongoing support from the software vendor, including provision for upgrades and enhancements, significantly reduces the value of the software to the customer and others in the marketplace. Accordingly, proponents do not believe that a Sunset Clause can be accounted for as an exchange but, rather, as a right of return since the difference between the discontinued software product and the replaced software product will always have more than a minimal difference in price.

View E: A software vendor should account for a Sunset Clause as a right to additional software products.

Most Sunset Clauses do not address whether the customer is required to return to the vendor a software product that has been discontinued or whether it can continue to utilize such products. Proponents of View E believe that if a customer retains the right to use software that has been discontinued by a vendor even if it is replaced by an equivalent product, then the customer's right to receive the additional software cannot be accounted for as an exchange right or a right of

return. Rather, it should be accounted for as either a right to an unspecified additional software product or an upgrade right for a specified upgrade or an enhancement as discussed further below.

Right to an Unspecified Additional Software Product

SOP 97-2 distinguishes PCS from the right to unspecified future products in paragraph 48, which states, in part:

...a vendor may agree to deliver software currently and to deliver *unspecified* additional software products in the future.... For example, the vendor may agree to deliver all new products to be introduced in a family of products over the next two years. These arrangements are similar to arrangements that include PCS in that future deliverables are unspecified. Nevertheless, they are distinguished from arrangements that include PCS because the future deliverables are products, not unspecified upgrades/enhancements.

Proponents of View E believe that when a Sunset Clause provides a customer with the right to any unspecified product that "replaces" the currently licensed version, including any unspecified new features and functionality included in that product, and that right cannot be accounted for as an exchange right or a right of return (based on the considerations discussed above), it should be accounted for as a right to receive unspecified future products based on the provisions of paragraph 48 of SOP 97-2.

Proponents of View E observe, however, that this accounting is only appropriate when the replacement product, including its features and functionality, is unspecified as of the date the agreement for the currently licensed product is entered into. If these items are specified, it will generally be appropriate to account for a Sunset Clause as a right to a specified future upgrade, an enhancement, or a specified additional software product, as discussed below.

Upgrade Right for a Specified Upgrade or Enhancement

When a Sunset Clause gives a customer the right to receive a software product that will "replace" the currently licensed version, and the product and/or the features and/or functionality that will be included in that product are specified (either contractually or through other communications to the customer), the right should be accounted for as either a right to a specified future upgrade/enhancement pursuant to paragraph 36 of SOP 97-2 or a specified additional software

product pursuant to paragraph 39 of SOP 97-2. In either case, the right should be accounted for as a separate element of the arrangement with the customer.

Proponents of View E observe that paragraph 50 of SOP 97-2 provides that if a customer has the right to receive additional software from a vendor and is not required to return, or does not lose the right to continue to use, the currently licensed product when the new product is delivered, the customer's right to receive the additional software cannot be accounted for as an exchange or right of return. Rather, it should be accounted for as a right to additional software products pursuant to paragraphs 39-49 of SOP 97-2.

Agenda Committee Decisions: *The Agenda Committee decided not to add this issue to the EITF agenda.*

2. The Application of the Two-Class Method to Master Limited Partnerships under FASB Statement No. 128, *Earnings per Share*

Summary

At the October 11, 2006 EITF Agenda Committee meeting, the Agenda Committee agreed to defer making a decision on this potential new issue pending a decision on the Committee's recommendation that the FASB and the IASB consider including this issue either as part of the short-term international convergence project on earnings per share or, alternatively, recommending that the FASB address this matter through the issuance of an FASB Staff Position. The IASB, at its Board meeting held on March 22, 2007, and the FASB, at its Board meeting held on March 28, 2007, decided independently to exclude this Issue from the scope of the short-term international convergence project on earnings per share. The respective staffs recommended, and the Boards agreed, that this Issue does not represent a current convergence difference between International Accounting Standard 33, *Earnings Per Share*, and Statement 128. That is, both Boards agreed that this Issue is a matter of whether to provide computational guidance for the application of the two-class method to a master limited partnership (MLP) and is not a matter of a difference between the principles of applying the two-class method. The Boards agreed not to address the computation guidance as part of the convergence project. As such, this Issue is being resubmitted to the EITF Agenda Committee for reconsideration. Based on the views expressed by the Boards, Issue 1 of the original EITF Agenda Committee submission has been replaced by an assertion that MLPs apply the two-class method. Therefore, the Issue for the EITF Agenda Committee to consider is whether computational guidance should be provided for applying the two-class method to MLPs in certain situations.

Background

Publicly traded MLPs often issue multiple classes of securities, each of which may participate in partnership distributions according to formulae specified in the partnership agreement. An investor's participation in the partnership's distributions often does not mirror the partnership's allocation of the entity's income or losses to the investor's capital accounts. In addition, distributions from the partnership often encompass returns on capital and returns of capital, as well as reallocations of capital between the different classes of investors.

Statement 128 and EITF Issue No. 03-6, "Participating Securities and the Two-Class Method under FASB Statement No. 128," appear to provide guidance that the multiple classes of securities issued by such partnerships meet the definition of participating securities, which requires the application of the two-class method on computing earnings per unit for MLPs. MLPs often have multiple classes of securities outstanding. Some classes are designed to maintain a zero capital balance (that is "earnings" are allocated to the capital accounts associated with that class in an amount that offsets any debit balance created by the distribution of cash). In periods in which earnings are not sufficient to cover distributions to the various partnership interests, the capital accounts of the remaining classes of partnership interests will absorb the "debit" created by the allocation of earnings to the preferential class. It is also not uncommon for such partnerships to encounter substantial timing differences between the distribution of cash and the recognition of income. This may be due to large non-cash charges occurring early in the entity's life (that is, depreciation, depletion, and amortization). Thus, early in their lives, these partnerships often will distribute cash in excess of their reported earnings. Alternatively, the partnership may operate in a seasonal industry, such that earnings and/or cash are generated primarily in one quarter, but cash distributions are made over the course of a year.

Statement 128 presumes that distributions from an entity represent a distribution of earnings. Thus, Statement 128 requires that distributions be allocated to each class of security based on its participation in such distributions, with net income being reduced by the amount of such distributions. This adjusted net income figure is then allocated to each class of security based on the manner in which each class of security would participate in earnings if the adjusted net income figure were to be distributed by the entity (that is, the process by which the undistributed earnings are allocated).

The interaction of the following items has resulted in varying interpretations of the manner in which earnings (or net loss) should be allocated to the various classes of securities that comprise the capital structure of MLPs:

- Timing differences between the recognition of earnings and the distribution of cash
- The existence of different "waterfalls" for allocating cash distributions, earnings, and losses of the partnership

- Shifting allocations of distributions to the various classes of security holders as the absolute level of distributions increases
- The existence of distributions that represent returns of capital, returns on capital, and reallocations of capital between interest holders
- The Statement 128 presumption that distributions of cash represent distributions of earnings.

For MLP's, the distributions of available cash to each of the interest holders typically do not mirror the allocation of income or loss to each of their respective capital accounts. Differences between the manner in which available cash is distributed and the manner in which earnings are allocated to the separate capital accounts of the MLP often include what amounts to a "return of capital" or a reallocation of capital between the various classes of security holders. Since MLPs can distribute available cash in excess of current period earnings, some have questioned the application of the two-class method for the initial allocation of cash distributions to non-ownership interest holders and whether this distribution should be considered a preferential distribution analogous to a preferred dividend before determining the earnings or losses that would need to be allocated to the remaining interest holders.

Accounting Issue and Alternatives

Whether computational guidance should be provided on the application of the two-class method for purposes of determining earnings per unit in certain situations, including (but not limited to):

- **Periods in which earnings of the MLP are less than distributions of available cash—how the excess distributions should be allocated**
- **Periods in which earnings of the MLP exceed distributions of available cash—how the undistributed excess earnings should be allocated**
- **Periods of net loss—how the net loss should be allocated.**

As discussed in paragraph 61 of Statement 128, under the two-class method, an entity first reduces its reported income by the distribution to each participating security. It then allocates the remaining earnings to common stock and participating securities in the manner in which each class would have participated if these remaining earnings had been distributed in the current period.

View A: Yes, computational guidance should be provided.

View B: No, computational guidance should not be provided.

Agenda Committee Decisions: *The Agenda Committee agreed to add this issue to the EITF agenda.*

FASB EMERGING ISSUES TASK FORCE

Proposed June 14, 2007 Meeting Agenda

<u>Issue Number</u>	<u>Issue</u>	<u>Proposed Time</u>	<u>Staff Assigned</u>
07-1	Accounting for Collaborative Arrangements Related to the Development and Commercialization of Intellectual Property	8:30–9:45	Bolash/ Beswick
07-3	Accounting for Nonrefundable Advance Payments for Goods or Services to Be Used in Future Research and Development Activities	9:45–10:15	Cosper/ Beswick
	*** BREAK ***	10:15–10:30	
06-11	Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards	10:30–11:30	Stevens/ Paul
	Administrative Matters	11:30–12:00	Cosper
	- New Issues		
	- Other Matters		
	*** LUNCH ***	12:00–1:00	
07-2	Accounting for Convertible Debt Instruments That Require or Permit Partial Cash Settlement upon Conversion	1:00–2:15	Stevens/ Sarno
	*** BREAK ***	2:15–2:30	
07-D	The Application of the Two-Class Method to Master Limited Partnerships under FASB Statement No. 128, <i>Earnings per Share</i> .	2:30–3:30	Wyatt/ Sarno

Status of Open Issues and Agenda Committee Items

The following represents the FASB staff's assessment of the status and immediate plans with respect to the open Issues on the Task Force's agenda. The Issues on the proposed agenda for the June 14, 2007 meeting are considered either high priority issues or issues on which meaningful progress can be made within the staff's given complement of resources. The staff's prioritization of issues is based primarily on the FASB staff's understanding of the level of diversity in practice created by each respective Issue, the financial reporting implications of that diversity, the current interaction, if any, of the Issues with active Board projects, and current resource availability among the staff (with respect to both time and relevant technical expertise).

Issue No.	Description	Date Added	Date(s) Discussed	Next Meeting	EITF Liaison	FASB Staff	Immediate Plans	Due Date - Next Deliverable
06-11	Accounting for Tax Benefits of Dividends on Share-Based Payment Awards	10/06	11/06, 3/07	6/07	Hauser	Stevens/ Paul	The FASB staff will prepare an Issue Summary Supplement for a future meeting.	June 14, 2007 EITF meeting
07-1	Accounting for Collaborative Arrangements Related to the Development and Commercialization of Intellectual Property	8/06	3/07	6/07	Schroeder	Bolash/ Beswick	The FASB staff will prepare an Issue Summary Supplement for a future meeting.	June 14, 2007 EITF meeting
07-2	Accounting for Convertible Debt Instruments That Require or Permit Partial Cash Settlement upon Conversion	1/07	3/07	6/07	Johnson	Stevens/ Sarno	The FASB staff will prepare an Issue Summary Supplement for a future meeting.	June 14, 2007 EITF meeting

Issue No.	Description	Date Added	Date(s) Discussed	Next Meeting	EITF Liaison	FASB Staff	Immediate Plans	Due Date - Next Deliverable
07-3	Accounting for Nonrefundable Advance Payments for Goods or Services to Be Used in Future Research and Development Activities	1/07	3/07	6/07	Hanson	Cosper/ Beswick	The FASB staff will prepare an Issue Summary Supplement for a future meeting.	June 14, 2007 EITF meeting
07-D	The Application of the Two-Class Method to Master Limited Partnerships under FASB Statement No. 128, <i>Earnings per Share</i> .	4/07	N/A	6/07	TBD	Wyatt/ Sarno	The FASB staff will prepare an Issue Summary for a future meeting	June 14, 2007 EITF meeting

Other EITF Issues including Inactive Issues Pending Developments in Board Projects

Issue No.	Description	Date Added	Date(s) Discussed	Next Meeting	FASB Staff	Immediate Plans	Due Date - Next Deliverable
00-27	Application of EITF Issue No. 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios," to Certain Convertible Instruments	5/00	11/00, 1/01	Not scheduled	TBD	Pending further progress on Phase II of the Board's liabilities and equity project.	N/A

Other EITF Issues including Inactive Issues Pending Developments in Board Projects							
Issue No.	Description	Date Added	Date(s) Discussed	Next Meeting	FASB Staff	Immediate Plans	Due Date - Next Deliverable
02-D	The Effect of Dual-Indexation both to a Company's Own Stock and to Interest Rates and the Company's Credit Risk in Evaluating the Exception under Paragraph 11(a)(1) of FASB Statement No. 133, <i>Accounting for Derivative Instruments and Hedging Activities</i>	3/02	N/A	Not scheduled	Jacobs	Pending further progress on Phase II of the Board's liabilities and equity project.	N/A
03-15	Interpretation of Constraining Conditions of a Transferee in a Collateralized Bond Obligation Structure	11/02	N/A	Not scheduled	Lusniak	The Board's project on QSPE's is not expected to address this Issue and, therefore, the FASB staff will bring this Issue to the Agenda Committee at a future meeting to determine whether to begin discussions on this Issue or to request that the Task Force remove this Issue from the agenda.	Future Agenda Committee or EITF Meeting

Other EITF Issues including Inactive Issues Pending Developments in Board Projects							
Issue No.	Description	Date Added	Date(s) Discussed	Next Meeting	FASB Staff	Immediate Plans	Due Date - Next Deliverable
05-4	The Effect of a Liquidated Damages Clause on a Financial Instrument Subject to EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock"	2/05	6/05, 9/05	06/07	Stevens	The FASB staff will bring this Issue to a future EITF Meeting to request that the Task Force remove this Issue from the agenda following the issuance of FSP EITF 00-19-2, "Accounting for Registration Payment Arrangements," on December 21, 2006.	June 2007 EITF Meeting – Admin. Session
06-12	Accounting for Physical Commodity Inventories for Entities within the Scope of the AICPA Audit and Accounting Guide, <i>Brokers and Dealers in Securities</i>	8/06	11/06	Not scheduled	Fanzini/ Jacobs	Pending the outcome of the Board's project to amend ARB No. 43, <i>Restatement and Revision of Accounting Research Bulletins</i> .	Future EITF Meeting

Issues Pending Further Consideration by the Agenda Committee							
Issue No.	Description	Date Added	Date(s) Discussed	Next Meeting	FASB Staff	Immediate Plans	Due Date - Next Deliverable
N/A	Application of EITF Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets," When a Special-Purpose Entity Holds Equity Securities and Whether an Investment That Is Redeemable at the Option of the Investor Should Be Considered an Equity Security or Debt Security	9/00	N/A	Not scheduled	Jacobs	Statement 155 did not address this Issue. Therefore, the FASB staff will bring this Issue to the Agenda Committee at a future meeting to determine whether to begin discussions on this Issue.	Future Agenda Committee