

**FASB Emerging Issues Task Force**

**Issue No.** 07-4

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

**Document:** Issue Summary No. 1, Supplement No. 3\*

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**Previously distributed EITF materials:** Issue Summary No. 1, dated May 23, 2007; Issue Summary No. 1, Supplement No. 1, dated August 28, 2007; Issue Summary No. 1, Supplement No. 2, dated November 14, 2007

**References:**

FASB Statement No. 128, *Earnings per Share* (FAS 128)

Proposed FSP EITF 03-6-a, "Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities" (proposed FSP EITF 03-6-a)

AICPA Statement of Position 95-2, "Financial Reporting by Nonpublic Investment Partnerships" (SOP 95-2)

International Accounting Standard 33, *Earnings per Share* (IAS 33)

EITF Issue No. 03-6, "Participating Securities and the Two-Class Method under FASB Statement No. 128" (Issue 03-6)

EITF Issue No. 04-8, "The Effect of Contingently Convertible Instruments on Diluted Earnings per Share" (Issue 04-8)

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**\* The alternative views presented in this Issue Summary Supplement are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination, exposes it for public comment, and it is ratified by the Board.**

*EITF Abstracts*, Topic No. D-72, "Effect of Contracts That May Be Settled in Stock or Cash on the Computation of Diluted Earnings per Share" (Topic D-72)

*EITF Abstracts*, Topic No. D-82, "Effect of Preferred Stock Dividends Payable in Common Shares on Computation of Income Available to Common Stockholders" (Topic D-82)

## **Background**

1. At the November 29, 2007 EITF meeting, the Task Force reached a consensus-for-exposure on this Issue and directed the staff to pursue the issuance of a draft abstract for public comment. A draft abstract for this Issue was posted to the FASB website on December 26, 2007, with a comment period that ended on February 8, 2008.
2. Comment letters received on the draft abstract have been distributed to Task Force members and have been analyzed by the FASB staff. At the March 12, 2008 EITF meeting, the Task Force will have the opportunity to consider those comment letters as it redeliberates the consensus-for-exposure in the draft abstract and discusses an application issue addressed in this Issue Summary Supplement. The Task Force will then be asked to affirm the consensus-for-exposure as a final consensus.

## **Application Question Received on the Draft Abstract**

3. Master limited partnership agreement will typically provide a specific time frame within which the general partner must determine and distribute available cash for that fiscal quarter to the GP, LPs, and IDR holder. This time frame generally ranges between 30 and 60 days from the end of the fiscal quarter. Because available cash for the period presented is not determined until the subsequent period, a question was raised about how the consensus-for-exposure should be applied for the period presented.<sup>1</sup> Paragraph 61(a) of FAS 128 states,

Income from continuing operations (or net income) shall be reduced by the amount of dividends declared in the current period for each class of stock and by the contractual amount of dividends (or interest on participating income bonds) that must be paid for the current period (for example, unpaid cumulative dividends).<sup>25</sup>

<sup>25</sup>Dividends declared in the current period do not include dividends declared in respect of prior-year unpaid cumulative dividends. Preferred dividends that are cumulative only if earned are deducted only to the extent that they are earned.

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<sup>1</sup> The views in this Issue Summary Supplement assume that the partnership agreement explicitly limits distributions to the IDR holder to a portion of available cash as defined in the partnership agreement.

Because income from continuing operations (or net income) is reduced by the contractual amount of dividends that must be paid for the current period, the staff believes that the underlying question is When does an MLP become contractually obligated to make distributions for the current period to the GP, LPs, and IDR holder?

### **Accounting Issues and Alternatives**

**Issue: Determining when the MLP becomes contractually obligated to make distributions to the GP, LPs, and IDR holder.**

*View A: The MLP becomes contractually obligated to make distributions once available cash has been determined by the GP.*

4. Proponents of View A believe that until available cash is determined by the GP, the amount of distributions to the LPs and IDR holder is not determinable. That is, the GP's determination of available cash determines (a) whether or not the IDR holder is entitled to receive a distribution and the amount of the distribution, if any, and (b) the amount of distribution the LPs are entitled to receive. Proponents of View A note that paragraph 61(a) of FAS 128 specifically states that net income should be reduced by the *contractual amount* of dividends that must be paid for the current period. Because the amount required to be distributed to the LPs and IDR holder is unknown until the amount of available cash is determined by the GP, proponents of View A believe that a contractual amount of distributions does not exist until the GP has determined the amount of available cash (that is, when the amount of distributions is determined). Accordingly, proponents of View A believe that net income for the current period should be reduced by the amount of available cash determined and, therefore, contractually obligated to be distributed in the current period. Since the GP has a contractually determined period of time after the end of a quarter to determine and distribute available cash, application of View A would result in available cash (the amount to be distributed) related to the end of a particular quarter being reflected in EPU in a subsequent quarter. Additionally, the specified threshold for the current period would be the IDR holder's share of available cash that is determined in the current period.

For example,

A partnership agreement indicates that within 45 days of the end of a quarter, the general partner is required to distribute 100 percent of available cash with respect to such quarter via a distribution waterfall. Further, the partnership agreement states that the IDR holder is not entitled to any distributions other than those provided through the preceding sentence. On April 30, 2008, the general partner determines that available cash for the first quarter ending March 31, 2008 is \$20,000 and based on the distribution waterfall, the IDR holder is entitled to a distribution of \$7,000. In computing EPU, net income for the second quarter would be reduced by \$20,000 (the amount of available cash determined and required to be distributed in the second quarter). The specified threshold for purposes of computing EPU for the IDR share would be \$7,000 (the required distribution to the IDR holder) because the partnership agreement limits distributions to the IDR holder to that amount. Net income for the first quarter would be unaffected by the distribution of \$20,000 because such amount was not determined and, therefore, not contractually required to be distributed as of the end of the first quarter.

5. Opponents of View A believe that the IDR is a participating security; however, they believe that View A implies that the IDR is not a participating security because the GP has discretion over whether any distributions are made to the IDR holder. Additionally, opponents of View A note that the effect of View A is that in the first quarter of an MLP's existence, no earnings would be allocated to the IDR holder because the GP has not determined available cash for that quarter. Finally, some opponents believe that an entity could manipulate EPU by delaying the determination and distribution of available cash.

6. Proponents of View A believe that the IDR meets the definition of a participating security because the IDR holder is entitled to receive distributions with the GP and the LPs based on the distribution waterfall, which is predetermined. Proponents of View A also note that while the GP has some discretion over the amount of available cash, its determination affects not only the IDR holder, but also the GP and LPs. Finally, proponents of View A do not believe that a GP would delay distributions of available cash to manipulate EPU. First, proponents of View A note

that EPU is not a relevant metric for MLPs. Second, delaying distributions has economic consequences because the value of these entities is primarily dependent on the amount and frequency of its distributions.

*View B: The MLP becomes contractually obligated to make distributions as of the end of the current reporting period.*

7. Proponents of View B believe that a distribution is contractually required at the end of the current reporting period. For practical reasons, the GP is given time after the end of the current reporting period to determine the exact amount of the distribution. However, the amount that is ultimately distributed is an amount as of the end of the current reporting period. Proponents of View B believe that an MLP would reduce income from continuing operations (or net income) by the amount of distributions that must be paid for the current reporting period. Because the amount of available cash that must be paid for the current reporting period is not determined until, for example, 45 days after the end of the current reporting period, proponents of View B believe that an MLP would not be able to compute EPU for the current reporting period until the GP has determined the amount of available cash that is required to be distributed relating to the current reporting period. The specified threshold under View B would be the amount of available cash that must be paid to the IDR holder for the current period. Proponents of View B acknowledge that an MLP may need to issue financial statements prior to the specified time frame elapsing. However, proponents of View B believe that to comply with reporting requirements, a GP would need to make the determination of available cash for financial reporting purposes prior to being contractually required.

8. Using the facts from the previous example, under View B, the MLP would not compute EPU for the first quarter until April 30, 2008 (the date that the amount of available cash is determined). Net income for the first quarter would be reduced by \$20,000 (the amount that must be paid for the current period) and the specified threshold for the first quarter would be \$7,000 (the amount that must be paid to the IDR holder for the current period). Therefore, the distribution of available cash would be reflected in EPU in the period that earnings associated with that available cash are generated.

9. Opponents of View B believe that it creates operational challenges. For example, an MLP may be required to issue financial statements prior to the date that the GP is required to determine available cash. Would the MLP have to delay issuing financial statements until available cash is determined? Alternatively, would an accounting requirement be dictating a business practice? Also, opponents of View B do not agree that View B would reflect the distribution of available cash in EPU in the period that earnings associated with that available cash are generated. Opponents of View B believe that distributions of available cash could be associated with earnings generated in previous periods because of the manner in which available cash is determined (that is, available cash for a given period incorporates cash flow forecasts for subsequent periods).

#### **Staff Recommendation**

10. The staff recommends View A for the reasons expressed in View A as well as the operational challenges associated with applying View B.

#### **Formal Comments Received on the Draft Abstract**

11. Three comment letters were received on the draft abstract from a preparer, an accounting organization, and an individual. The respondents generally agreed with the Task Force's consensus-for-exposure.

12. One respondent commented that,

The use of the "as if" distributed model when earnings are in excess of cash distributions for MLPs that do not have specific limits on the participation of inventive distribution rights produces results that while thought to improve comparability do not present the economic reality of the operations of the partnership...the use of available cash in those calculations does not produce meaningful information.

13. The consensus-for-exposure requires an entity to assess whether a specified threshold, as described in Issue 03-6, exists. The Task Force concluded that a specified threshold would only exist if the terms of the partnership agreement explicitly limited distributions to the IDR holder

to a predetermined portion of available cash as defined in the partnership agreement. In such a case, the MLP would not allocate undistributed earnings to the IDR holder. The Task Force also concluded that without an explicit contractual limitation, a specified threshold would not exist and therefore an MLP would allocate undistributed earnings to the IDR holder using the distribution waterfall. The Task Force reached this consensus-for-exposure to be consistent with Issue 03-6 and because when a specified threshold exists, the resulting EPU reflects what the IDR holder would be contractually entitled to receive if all earnings for the period were distributed. The Task Force's consensus-for-exposure also resulted in EPU being consistent with the economics of the partnership, even though that is not an objective of either FAS 128 or Issue 03-6.

14. Issue 03-6 requires that undistributed earnings be allocated to a participating security based on the security's contractual participation rights as if all earnings had been distributed. When a specified threshold does not exist, the staff believes that the IDR holder has the ability to participate in undistributed earnings. While this may not mirror the way in which earnings are allocated to the partners' accounts, the staff believes that it does reflect what the IDR holder would be contractually entitled to receive if all earnings had been distributed. The staff believes that the comment raised by this constituent is consistent with support for the previous views presented to the Task Force. Accordingly, the staff will not ask the Task Force to reconsider any aspect of the draft abstract for this comment.

### **Other Considerations**

15. Suggested wording changes to the draft abstract to incorporate View A (that is, the staff's recommendation) are reflected in the marked draft abstract included in Appendix 07-4A. The staff believes that there are no additional issues or comments that warrant consideration by the Task Force at the March 12, 2008 EITF meeting.

**"Application of the Two-Class Method under FASB Statement No. 128 to Master Limited Partnerships"**

**Dates Discussed:** June 14, 2007; September 11, 2007; November 29, 2007; [March 12, 2008]

**Objective**

**1. The objective of this Issue is to improve the comparability of earnings per unit (EPU) calculations for master limited partnerships (MLPs) with incentive distribution rights (IDRs) in accordance with Statement 128 and its related interpretations.**

<p><b>All paragraphs in this Issue have equal authority. Paragraphs in bold set out the main principles.</b></p>
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**Background**

2. Publicly traded MLPs often issue multiple classes of securities that may participate in partnership distributions according to a formula specified in the partnership agreement. A typical MLP consists of publicly traded common units held by limited partners (LPs), a general partner (GP) interest, and IDRs. Depending on the structure of the MLP, the IDRs may be a separate class of nonvoting limited partner interest that the GP initially holds but generally may transfer or sell apart from its overall interest. Alternatively, the IDRs may be embedded in the GP interest such that they cannot be detached and transferred apart from the GP's overall interest.

3. Generally, within the contractually determined period of time following the end of a reporting period, the partnership agreement obligates the GP to distribute 100 percent of the partnership's available cash with respect to such reporting period ~~at the end of each quarter~~ to the GP and LPs via a distribution waterfall (that is, a schedule that prescribes distributions to the GP and LPs at each threshold). When certain thresholds are met, the distribution waterfall further allocates available cash to the holder of the separate class of nonvoting limited partner interest (the IDR holder) or, when the IDR is embedded in the GP interest, to the GP. The net income (or loss) of the partnership is allocated to the capital accounts of the GP and LPs based on their respective sharing of income or losses specified in the partnership agreement, but only after taking into account any priority income allocations resulting from incentive distributions.

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<sup>2</sup> ~~This draft abstract is being exposed for a public comment period that will end on February 8, 2008.~~

4. As a result of the capital structure of MLPs, the partnership is required to apply the two-class method to calculate EPU. Paragraph 61 of Statement 128 describes the two-class method as an earnings allocation formula that determines earnings per share for each class of common stock and participating security according to dividends declared (or accumulated) (that is, distributed earnings) and participation rights in undistributed earnings. Undistributed earnings are allocated to the common unit(s) and participating securities as if all earnings for the period had been distributed. Pursuant to Issue 3 of Issue 03-6, undistributed earnings for a period are allocated to a participating security based on the contractual participation rights of the security to share in those current period earnings as if all earnings for the period had been distributed. When applying the two-class method to the interests of the GP and LPs in MLPs, questions have been raised about the effect of IDRs on the computation of EPU.

## Scope

**5. This Issue applies to MLPs that are required to make incentive distributions when certain thresholds have been met that are accounted for as equity distributions.**

6. An MLP may issue IDRs that are a separate class of nonvoting LP interest that the GP initially holds or IDRs that are embedded in the GP interest and therefore cannot be detached or transferred apart from the GP's overall interest. IDRs that are a separate class of non-voting limited partner interest generally may be transferred or sold apart from the GP interest. This Issue applies to all MLPs that (a) are required to make incentive distributions when certain thresholds have been met (regardless of whether the IDRs are a separate LP interest or embedded in the GP interest) and (b) have accounted for the incentive distributions as equity distributions (as opposed to compensation costs). The determination of whether the incentive distribution is an equity distribution or compensation expense is outside the scope of this Issue.

## Other Presentation Matters

**7. IDRs that are a separate class of LP interest are participating securities because they have a right to participate in earnings with common equity holders. Therefore, current-period earnings shall be allocated to the GP, LPs, and IDR holder using the two-class method in Statement 128 to calculate EPU.**

8. When calculating EPU under the two-class method for an MLP, net income (or loss) shall be reduced (or increased) by the amount of distributions to the GP, LPs, and IDR holder ~~for~~ determined in accordance with the contractual terms in the period presented. The undistributed earnings, if any, shall be allocated to the GP, LPs, and IDR holder utilizing the contractual terms of the partnership agreement. The distribution waterfall (that is, a schedule that prescribes distributions to the various interest holders at each threshold) for available cash specified in the partnership agreement contractually mandates the way in which earnings are distributed for the period presented. The undistributed earnings shall be allocated to the IDR holder based on the contractual participation rights of the IDR to share in current period earnings. Therefore, if the partnership agreement includes a "specified threshold" as described in Example F in paragraph 16 of Issue 03-6, an MLP shall not allocate undistributed earnings to the IDR holder once the specified threshold has been met. In determining whether a specified threshold exists, an MLP should evaluate whether distributions to the IDR holder would be contractually limited to the

~~holder's share of available cash as defined in the partnership agreement determined in the period presented. For example, if the partnership agreement contractually limits distributions to the IDR holder to available cash as defined in the partnership agreement and all available cash for the period presented has been distributed, then the MLP would not allocate undistributed earnings to the IDR holder. However, if the partnership agreement is silent or does not explicitly limit distributions to the IDR holder to the holder's share of available cash determined in the period presented, then a specified threshold would not exist and the MLP would allocate undistributed earnings to the IDR holder utilizing the distribution waterfall for available cash specified in the partnership agreement.~~

9. Any excess of distributions over earnings shall be allocated to the GP and LPs based on their respective sharing of losses specified in the partnership agreement (that is, the provisions for allocation of losses to the partners' capital accounts for the period presented). If the IDR holders do not share in losses, the excess of distribution over earnings amount would not be allocated to the IDR holders. However, if the IDR holders have a contractual obligation to share in the losses of the MLP on a basis that is objectively determinable (as described in paragraphs 17 and 18 of Issue 03-6), the excess of distributions over earnings shall be allocated to the GP, LPs, and IDR holders based on their respective sharing of losses specified in the partnership agreement for the period presented.

**10. IDRs that are embedded in the GP interest are not separate participating securities. However, because the GP and LP interests are separate classes of equity, the two-class method shall be applied in computing EPU for the GP and LP interests.**

11. When calculating EPU under the two-class method for an MLP, net income (or loss) shall be reduced (or increased) by the amount of distributions to the GP (including the distribution rights of the embedded IDRs) and LPs determined in accordance with the contractual terms in ~~for~~ the period presented. Undistributed earnings, if any, shall be allocated to the GP (including the distribution rights of the embedded IDRs) and LPs utilizing the contractual terms of the partnership agreement. The distribution waterfall for available cash specified in the partnership agreement contractually mandates the way in which earnings are distributed for the period presented. The undistributed earnings shall be allocated to the GP (with respect to the distribution rights of an embedded IDR) based on the contractual participation rights of the IDR to share in current period earnings. Therefore, if the partnership agreement includes a "specified threshold" as described in Example F in paragraph 16 of Issue 03-6, an MLP shall not allocate undistributed earnings to the GP (with respect to the distribution rights of an embedded IDR) once the specified threshold has been met. In determining whether a specified threshold exists, an MLP should evaluate whether distributions to the GP (with respect to the distribution rights of an embedded IDR) would be contractually limited to the GP's share (with respect to the distribution rights of an embedded IDR) of available cash as defined in the partnership agreement determined in the period presented. ~~For example, if the partnership agreement contractually limits distributions to the GP (with respect to the distribution rights of an embedded IDR) to available cash as defined in the partnership agreement and all available cash for the period presented has been distributed, then the MLP would not allocate undistributed earnings to the GP (with respect to the distribution rights of an embedded IDR). However, if the partnership agreement is silent or does not explicitly limit distributions to the GP (with respect to the distribution rights of an embedded IDR) to the GP's share (with respect to the distribution~~

rights of an embedded IDR) of available cash determined in the period presented, then a specified threshold would not exist and the MLP would allocate undistributed earnings to the GP (with respect to the distribution rights of an embedded IDR) utilizing the distribution waterfall for available cash specified in the partnership agreement. The excess of distributions over earnings shall be allocated to the GP and LPs based on their respective sharing of losses specified in the partnership agreement for the period presented.

## **Transition**

12. This Issue shall be effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Earlier application is not permitted. This Issue shall be applied retrospectively for all financial statements presented.

<b>The provisions of this Issue need not be applied to immaterial items.</b>
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## **References**

FASB Statement No. 128, *Earnings per Share*

Proposed FSP EITF 03-6-a, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities*

AICPA Statement of Position 95-2, "Financial Reporting by Nonpublic Investment Partnerships"

International Accounting Standard 33, *Earnings per Share*

EITF Issue No. 03-6, "Participating Securities and the Two-Class Method under FASB Statement No. 128"

EITF Issue No. 04-8, "The Effect of Contingently Convertible Instruments on Diluted Earnings per Share"

EITF Topic No. D-72, "Effect of Contracts That May Be Settled in Stock or Cash on the Computation of Diluted Earnings per Share"

EITF Topic No. D-82, "Effect of Preferred Stock Dividends Payable in Common Shares on Computation of Income Available to Common Stockholders"