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

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Date previously discussed: None

Previously distributed EITF materials: None

References:

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

FASB Statement No. 129, *Disclosure of Information about Capital Structure* (FAS 129)

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)

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)

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

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* **The alternative views presented in this Issue Summary 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.**

Background

1. Publicly traded master limited partnerships (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 (the Common Units), a general partner interest (the GP Interest), and incentive distribution rights (the IDRs). The IDRs represent a separate class of non-voting limited partner interest that the general partner (GP) initially holds but may transfer or sell separately from its GP Interest. IDR holders do not have an ownership interest in the partnership.

2. The partnership agreement obligates the GP to distribute 100 percent of the partnership's Available Cash[1] at the end of each quarter to the limited partners (LPs), GP, and, when certain thresholds are met, IDR holders via a distribution waterfall (that is, a schedule that prescribes distributions to the LPs, GP, and IDR holders at each threshold). The partnership agreement further states that IDR holders are not entitled to distributions other than that provided in the distribution waterfall for Available Cash. The net income (or loss) of the partnership is allocated to the capital accounts of the GP and LPs based on their ownership percentages, but only after taking into account any priority income allocations to IDR holder(s)[2] and losses previously allocated to the partners. Therefore, 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.

3. It is not uncommon for MLPs 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

[1] Available Cash is typically defined in the partnership agreement as all cash on hand at the end of each quarter less cash retained by the partnership as capital to (i) operate the business (for example, future capital expenditures), (ii) comply with applicable law, debt, and other agreements, and (iii) provide funds for distribution to the Common Unit, GP, and IDR holders for any one or more of the next four quarters.

[2] The priority allocation to the IDR holder(s) is the allocation of net income equal to the amount of the cash distribution to the IDR holder(s) in a given period to such holder's "capital account" (effectively, maintaining such account at a zero balance over the life of the partnership).

are generated primarily in one quarter, but cash distributions are made over the course of a year. In periods during 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 IDR holders.

4. FAS 128 and Issue 03-6 define a participating security, respectively, as,

> Securities that may participate in dividends with common stocks according to a predetermined formula (for example, two for one) with, at times, an upper limit on the extent of participation (for example, up to, but not beyond, a specified amount per share).
>
> …a security that may participate in undistributed earnings with common stock, whether that participation is conditioned upon the occurrence of a specified event or not.

Based on those definitions, the GP interest meets the definition of a participating security, which requires the application of the two-class method when computing earnings per unit. Paragraph 61 of FAS 128 states, in part,

> The two-class method is an earnings allocation formula that determines earnings per share for each class of common stock and participating security according to dividends declared (or accumulated) and participation rights in undistributed earnings. Under that method:
>
> a. 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).
> b. The remaining earnings shall be allocated to common stock and participating securities to the extent that each security may share in earnings as if all of the earnings for the period had been distributed. The total earnings allocated to each security shall be determined by adding together the amount allocated for dividends and the amount allocated for a participation feature.
> c. The total earnings allocated to each security shall be divided by the number of outstanding shares of the security to which the earnings are allocated to determine the earnings per share for the security.
> d. Basic and diluted EPS data shall be presented for each class of common stock. [Footnote reference omitted.]

5. Questions have been raised regarding the application of the two-class method to MLPs. Specifically, constituents have asked whether IDRs represent a participating security pursuant to the guidance in FAS 128 and Issue 03-6, and whether current period earnings of the partnership should be allocated to the holders of incentive distribution rights.

Accounting Issues and Alternatives

Issue: When applying the two-class method under FAS 128, whether current period earnings of an MLP should be allocated to holders of IDRs.

View A: The IDRs are not participating securities. Therefore, current period earnings should <u>*not*</u> *be allocated to holders of IDRs.*

6. Proponents of View A do not believe that IDRs qualify as a participating security. In Issue 2 of Issue 03-6, the Task Force reached a consensus that for purposes of applying paragraphs 60 and 61 of FAS 128,

> …a participating security is a security that may participate in undistributed earnings with common stock, whether that participation is conditioned upon the occurrence of a specified event or not.

Proponents of View A do not believe that IDR holders participate in undistributed earnings because the terms of the partnership agreement limit the holder's distribution to Available Cash, which is specifically defined in the partnership agreement. Once Available Cash has been distributed, IDR holders are not entitled to any other earnings. Since the GP is obligated to distribute 100 percent of the Available Cash, the partnership agreement would not entitle IDR holders to any other distribution of earnings.

7. Proponents of View A also note that IDR holders do not have an ownership interest in the partnership. Therefore, proponents of View A believe that a distribution to IDR holders should be considered a preferential distribution akin to a preferred dividend that reduces the amount of

net income (or increases the amount of net loss) allocated to the interest holders. Exhibit 07-4A provides an illustration of the application of this view in calculating basic earnings per unit.

View B: IDRs are participating securities. Therefore, current period earnings should be allocated to IDR holders. Undistributed earnings should be allocated to the LPs, GP, and IDR holders as if the undistributed earnings were Available Cash.

8. Proponents of View B believe that IDRs are participating securities based on the guidance in Issue 2 of Issue 03-6, because of the presumption in FAS 128 that distributions from an entity represent a distribution of earnings. Proponents of View B contend that the required distribution of Available Cash to IDR holders represents a distribution of earnings. Since FAS 128 requires the allocation of earnings to be made "as if" all earnings were distributed and IDR holders are entitled to a distribution of earnings through the distribution waterfall, proponents of View B believe that IDR holders participate in undistributed earnings. Proponents of View B also point to paragraph 60(a) of FAS 128, which defines a participating security as,

> Securities that may participate in dividends with common stocks according to a predetermined formula (for example, two for one) with, at times, an upper limit on the extent of participation (for example, up to, but not beyond, a specified amount per share).

Proponents of View B believe that this further supports their assertion that IDRs are participating securities because IDR holders are entitled to participate in distributions with LPs according to the distribution waterfall specified in the partnership agreement.

9. Proponents of View B believe that undistributed earnings should be allocated to IDRs using the distribution waterfall as if the undistributed earnings were Available Cash. Proponents of View B acknowledge that this allocation is pro forma in nature and that it does not reflect the actual economics of the partnership arrangement. However, proponents of View B believe that allocation of undistributed earnings to IDR holders is consistent with the guidance in paragraph 61(b) of FAS 128, which states that under the two-class method,

> The remaining earnings shall be allocated to the common stock and participating securities to the extent that each security may share in earnings *as if all earnings for the period had been distributed*. [Emphasis added.]

Exhibit 07-4A provides an illustration of the application of this view in calculating basic earnings per unit.

View B': IDRs are participating securities. Distributions to IDR holders are capped according to a formula based on Available Cash that has already been fully distributed; therefore, IDRs do not have any remaining contractual participation right in current period earnings.

10. Similar to proponents of View B, proponents of View B' believe that IDRs are participating securities. However, proponents of View B' believe that IDR holders do not have any further contractual participation right in earnings once Available Cash has been distributed. In Issue 3 of Issue 03-6, the Task Force reached a consensus that,

> …undistributed earnings for a period should be allocated to a participating security based on the *contractual participation rights of the security* to share in those current earnings as if all of the earnings for the period had been distributed. [Emphasis added.]

11. Proponents of View B' highlight the fact that the partnership agreement explicitly limits distributions to IDR holders to the distribution waterfall for Available Cash. A similar limitation does not exist for the GP and LPs who have an ownership interest in the partnership. Further, Available Cash is defined in the partnership agreement as the amount of cash on hand at the end of a quarter less capital requirements. Although the guidance in FAS 128 presumes that all earnings are distributed as cash, proponents of View B' believe that the terms of the partnership agreement limit distributions to IDR holders to Available Cash as defined in the agreement. Therefore, proponents of View B' do not believe that undistributed earnings should be allocated to IDRs because their contractual participation right is capped according to a formula based on Available Cash, as defined, and that amount has already been distributed to the IDR holders. View B' proponents note that the earnings per unit calculated under View B' is the same as under View A, however, the presentation of earnings per unit is different under each of the two views.

That is, under View A, the distribution to IDRs are shown as a preferential distribution that reduces net income (or loss) available to the GP and LPs, whereas under View B' the distribution to IDRs are presented as a distribution to a participating security holder. Exhibit 07-4A provides an illustration of the application of this view in calculating basic earnings per unit.

International Convergence

12. There is currently a short-term convergence earnings per share project underway at the FASB and the IASB. Some have questioned whether this Issue should be addressed as part of that project. Both the FASB and the IASB decided independently to exclude this Issue from the scope of the short-term convergence project on earnings per share because the two-class method does not represent a convergence difference between FAS 128 and IAS 33.

13. The definition of a participating security is the same under FAS 128 and IAS 33. However, there is no Issue 03-6 equivalent under IFRS that further defines or clarifies the definition of a participating security. Therefore, a consensus on any of the views in this Issue Summary would not diverge from IFRS.

Transition and Effective Date

14. The consensus on this Issue shall be effective for financial statements issued for fiscal years beginning after December 15, 2007, and interim periods within those fiscal years. Earlier application is not permitted. The staff recommends that the guidance in this Issue be applied retrospectively for all financial statements presented. The staff is recommending retrospective application for comparative purposes and because it would be consistent with the application of previous consensuses and other accounting standards that have affected the computation and presentation of earnings per share information (such as, Topics D-72 and D-82, and Issues 03-6 and 04-8).

Exhibit 07-4A

APPLICATION OF THE ALTERNATIVE VIEWS

A1. The following example illustrates the application of the alternative views set forth in this Issue Summary.

> Partnership ABC has 9,800 Common Units outstanding held by the limited partners (LPs) and 200 GP units outstanding held by the general partner (GP) during the second quarter of 20X7. The allocation of net income to the capital accounts of the LPs and GP is based on their ownership percentages (98 percent and 2 percent, respectively) after giving effect to any priority income allocations to the IDR holder(s).[3]
>
> The GP also holds incentive distribution rights (IDRs), which are a non-voting limited partnership interests that entitle the holder to cash distributions when certain thresholds are achieved. The GP is obligated to distribute 100 percent of the partnership's Available Cash at the end of each quarter based on a distribution waterfall specified in the partnership agreement. At the end of the first quarter 20X7, the partnership had Available Cash of $20,000 (fully distributed to the LPs, GP, and IDR holders) and net income of $50,000. The following table illustrates the cumulative amount of Available Cash that would be distributed to the Common Units, GP Interest, and IDRs at each of the thresholds based on the distribution waterfall in Partnership ABC's partnership agreement:

		Waterfall Percentage			**Cumulative** Distribution by Interest			
	Distribution per Common Units (LPs)	LPs	GP	IDRs	LPs[4]	GP[5]	IDRs	Total
1st Threshold	$ 0.40	98%	2%	0%	$ 3,920.00	$ 80.00	$ -	$ 4,000.00
2nd Threshold	$ 0.50	85%	2%	13%	$ 4,900.00	$ 103.06	$ 149.88[6]	$ 5,152.94
3rd Threshold	$ 0.60	75%	2%	23%	$ 5,880.00	$ 129.19	$ 450.42[7]	$ 6,459.61
Thereafter	N/A	50%	2%	48%				

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[3] The priority allocation to the IDR holder(s) is the allocation of net income equal to the amount of the cash distribution to the IDR holder(s) in a given period to such holder's "capital account" (effectively, maintaining such account at a zero balance over the life of the partnership).

[4] Cumulative distribution to the LPs equals the distribution per common unit at each threshold multiplied by 9,800 common units.

[5] Cumulative distribution to the GP equals 2 percent of the total cumulative distribution at each threshold.

[6] [$5,152.94 (total cumulative distribution at 2nd threshold) − $ 4,000 (total distribution at 1st threshold)] multiplied by 13% waterfall percentage.

[7] $149.88 (distribution to IDRs at 2nd threshold) plus [($6,459.61 (total cumulative distribution at 3rd threshold) − $5,152.94 (total cumulative distribution at 2nd threshold)) multiplied by 23% waterfall percentage].

Application of the Two-Class Method under View A

First Quarter 20X7

Net Income		$50,000.00
Less Preferential Distribution to IDRs		6,949.80[8]
Net Income Available to GP and LPs		43,050.20
Less distributions paid:		
General Partner	$ 400.00[9]	
Limited Partners	12,650.20[10]	
		13,050.20
Undistributed Q1 20X7 earnings		$30,000.00

Allocation of undistributed earnings:

To general partner:
2% ownership interest × $30,000 = $600
$600 ÷ 200 units = $3.00 per unit

To limited partners:
98% ownership interest × $30,000 = $29,400
$29,400 ÷ 9,800 units = $3.00 per unit

Basic EPU amounts:

	General Partner	Limited Partners
Distributed earnings	$2.00	$1.29
Undistributed earnings	3.00	3.00
Total	$5.00	$4.29

[8] $450.42 cumulative distribution to IDR holders for 3rd threshold plus [($20,000 (Available Cash) − $6,459.61 (total cumulative distribution for 3rd threshold)) multiplied by 48% waterfall percentage].
[9] $129.19 cumulative distribution to GP for 3rd threshold plus [($20,000 (Available Cash) − $6,459.61 (total cumulative distribution for 3rd threshold)) multiplied by 2% waterfall percentage].
[10] $5,880 cumulative distribution to LPs for 3rd threshold plus [($20,000 (Available Cash) − $6,459.61 (total cumulative distribution for 3rd threshold)) multiplied by 50% waterfall percentage].

Application of the Two-Class Method under View B

<u>First Quarter 20X7</u>

Net Income			$50,000
Less distributions paid:			
	Incentive Distribution Rights	$ 6,949.80	
	General Partner	400.00	
	Limited Partners	12,650.20	
			20,000
Undistributed Q2 20X7 earnings			$30,000

Allocation of undistributed earnings:

To incentive distribution rights:
48% cash waterfall percentage × $30,000 = $14,400[11]

To general partner:
2% cash waterfall percentage × $30,000 = $600
$600 ÷ 200 units = $3.00 per unit

To limited partners:
50% cash waterfall percentage × $30,000 = $15,000
$15,000 ÷ 9,800 units = $1.53 per unit

Basic EPU amounts:

	General Partner	Limited Partners
Distributed earnings	$2.00	$1.29
Undistributed earnings	3.00	1.53
Total	$5.00	$2.82

[11] IDR holders do not have an ownership interest in the partnership. Therefore, undistributed earnings per unit cannot be calculated.

Application of the Two-Class Method under View B'

First Quarter 20X7

Net Income		$50,000
Less distributions paid:		
Incentive Distribution Rights	$ 6,949.80	
General Partner	400.00	
Limited Partners	12,650.20	
		20,000
Undistributed Q2 20X7 earnings		$30,000

Allocation of undistributed earnings:

To incentive distribution rights:
0% cash waterfall percentage × $30,000 = $0[12]

To general partner:
2% cash waterfall percentage × $30,000 = $600
$600 ÷ 200 units = $3.00 per unit

To limited partners:
98% cash waterfall percentage × $30,000 = $29,400
$29,400 ÷ 9,800 units = $3.00 per unit

Basic EPU amounts:

	General Partner	Limited Partners
Distributed earnings	$2.00	$1.29
Undistributed earnings	3.00	3.00
Total	$5.00	$4.29

[12] Because Available Cash has been fully distributed, the IDR holders would not be entitled to any further distribution of undistributed earnings.