EITF ABSTRACTS

Issue No. 07-4

Title: 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

References:
- FASB Statement No. 128, *Earnings per Share*
- 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”

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.

All paragraphs in this Issue have equal authority. Paragraphs in bold set out the main principles.
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, the partnership agreement obligates the GP to distribute 100 percent of the partnership's available cash (as defined in the partnership agreement) at the end of each reporting period to the GP and LPs via a distribution waterfall (that is, a schedule that prescribes distributions to the GP and LPs at each threshold) within a contractually determined period of time following the end of a reporting period. 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.
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 cost is outside the scope of this Issue.

Other Presentation Matters

7. IDR s 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, LP, 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) for the current reporting period shall be reduced (or increased) by the amount of available cash that has been or will be distributed to the GP, LPs, and IDR holder for that reporting period. For example, assume a partnership agreement requires the GP to distribute available cash within 60 days following the end of each fiscal quarter. The MLP is required to file financial statements with a regulatory agency within 45 days following the end of each fiscal quarter. In order to compute EPU for the first quarter, the GP shall determine the amount of available cash that will be distributed to the GP, LPs, and IDR holder for that first quarter. The MLP would reduce (or increase) net income (or loss) by that amount in computing undistributed earnings that must be allocated to the GP, LPs, and IDR holder in calculating EPU for the first quarter.
9. 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.

10. In determining whether a specified threshold exists, an MLP shall evaluate whether distributions to the IDR holder would be contractually limited to available cash as defined in the partnership agreement if all earnings for the period were distributed. For example, if the partnership agreement contractually limits distributions to the IDR holder to the holder's share of available cash as defined in the partnership agreement, then the specified threshold for the current reporting period would be the holder's share of available cash that has been or will be distributed for that reporting period. The MLP would not allocate undistributed earnings to the IDR holder because the holder's share of available cash is the maximum amount that the IDR holder would be contractually entitled to receive if all earnings for the current reporting period were distributed. However, if the partnership agreement is silent or does not explicitly limit distributions to the IDR holder to available cash, then the MLP would allocate undistributed earnings to
the IDR holder utilizing the distribution waterfall for available cash specified in the partnership agreement.

11. 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.

12. **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.

13. When calculating EPU under the two-class method for an MLP, net income (or loss) for the current reporting period shall be reduced (or increased) by the amount of available cash that has been or will be distributed to the GP (including the distribution rights of the embedded IDRs) and LPs for that reporting period. For example, assume that a partnership agreement requires the GP to distribute available cash within 60 days
following the end of each fiscal quarter. The MLP is required to file financial statements with a regulatory agency within 45 days following the end of each fiscal quarter. In order to compute EPU for the first quarter, the GP shall determine the amount of available cash that will be distributed to the GP and LPs for that first quarter. The MLP would reduce (or increase) net income (or loss) by that amount in computing undistributed earnings that must be allocated to the GP (including the distribution rights of the embedded IDRs) and LPs in calculating EPU for the first quarter.

14. 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.

15. In determining whether a specified threshold exists, an MLP shall evaluate whether distributions to the GP (with respect to the distribution rights of an embedded IDR) would be contractually limited to available cash as defined in the partnership agreement if all earnings for the period were distributed. For example, if the partnership agreement
contractually limits distributions to the GP (with respect to the distribution rights of an embedded IDR) to the holder's share of available cash as defined in the partnership agreement, then the specified threshold for the current reporting period would be the GP's share (with respect to the distribution rights of an embedded IDR) of available cash that has been or will be distributed for that reporting period. The MLP would not allocate undistributed earnings to the GP (with respect to the distribution rights of an embedded IDR) because the GP's share (with respect to the distribution rights of an embedded IDR) of available cash is the maximum amount that the GP (with respect to the distribution rights of an embedded IDR) would be contractually entitled to receive if all earnings for the current reporting period were distributed. 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 available cash, then 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.

16. 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 for the period presented.
**Transition**

17. 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.

The provisions of this Issue need not be applied to immaterial items.

**Board Ratification**

18. At its March 26, 2008 meeting, the Board ratified the consensus reached by the Task Force in this Issue.

**Status**

19. No further EITF discussion is planned.
Suggested Index Entries for Issue No. 07-4, “Application of the Two-Class Method under FASB Statement No. 128 to Master Limited Partnerships”

EARNINGS PER SHARE

Master Limited Partnerships

. . Application of the Two-Class Method under Statement 128 07-4

MASTER LIMITED PARTNERSHIPS

Application of the Two-Class Method under Statement 128 07-4

PARTNERSHIPS

Master Limited Partnerships (MLPs)

. . Application of the Two-Class Method under Statement 128 07-4