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EITF Snapshot

Audit and Enterprise Risk Services

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This *EITF Snapshot* summarizes the September 11, 2007, meeting of the Emerging Issues Task Force.

Initial Task Force decisions ("tentative conclusions") are exposed for a comment period upon ratification by the Financial Accounting Standards Board. At its first scheduled meeting after the comment period, the Task Force considers comments received and, as warranted, affirms its tentative conclusions as consensuses. Consensuses are then provided to the Board for ratification.

After the September 26, 2007, FASB meeting, official EITF minutes, including the results of the FASB's ratification process, will be posted to Technical Library: The Deloitte Accounting Research Tool and to the FASB's Web site. EITF Issue summaries also can be found on those sites.

Issue 07-1 Accounting for Collaborative Arrangements

STATUS: Tentative conclusion reached.

AFFECTS: Entities, particularly those in the biotechnology, pharmaceutical, and motion picture industries, that participate in collaborative arrangements for the development and commercialization of products.[1]

BACKGROUND: Entities may seek partners to share in the development and commercialization of resource-intensive (and generally uncertain) products. Although these arrangements take many forms, their substance is one of active participation by the partners and a sharing of the costs and revenues of the endeavor. Consider the following example:

Company B, a biotechnology entity, has a promising drug candidate. Company P is a pharmaceutical company with an established manufacturing facility and distribution chain. The companies enter into an arrangement for the joint development and commercialization of the potential drug. No legal entity is created; however, B and P agree that:

- B will perform the development activities.
- P will perform the commercialization activities (if and when the drug is approved for sale).
- B and P will share in the costs and revenues (if any) of the endeavor.

SUMMARY: The Task Force affirmed previous tentative conclusions as follows:

Issue 1 — A collaborative arrangement is a contractual arrangement in which the parties (a) are active participants to the arrangements and (b) are exposed to significant risks and rewards that depend on the commercial success of the endeavor.

Issue 2 — Costs incurred and revenues generated on sales to third parties should be reported by the partners on the appropriate line item in their respective income statements, pursuant to Issue 99-19[2] (i.e., on the basis of whether the partner is a principal to the transaction).

Issue 3 — The income statement characterization of amounts owed to (due from) the partners should be based on other authoritative literature, if the payments are within the scope of such literature. Otherwise, characterization of the payments should be based on (1) an analogy to other

[1] A collaborative arrangement may include a legal entity in some portion of the arrangement. Any consensus reached on Issue 07-1 does not affect the accounting for that legal entity under existing generally accepted accounting principles.

[2] EITF Issue No. 99-19, "Reporting Revenue Gross as Principal Versus Net as an Agent."

authoritative literature or (2) a reasonable, rational, and consistently applied accounting policy election based on the nature and contractual terms of the arrangement and the nature of the respective entity's business operations.

Issue 4 — The partners should disclose, in the footnotes to their annual financial statements, (1) income statement amounts (and related classification) attributable to transactions between the participants, (2) amounts owed to (due from) the participants, and (3) information regarding the nature and purpose of the arrangement, rights and obligations under the arrangement, the stage of the underlying endeavor's life cycle, and any accounting policies for the collaborative arrangement.

TRANSITION: A consensus would be effective for annual periods beginning after December 15, 2007, and would be applied as a change in accounting principle through retrospective application to all periods presented.

NEXT STEPS: FASB ratification is expected at the Board's September 26, 2007, meeting, after which the tentative conclusion will be exposed for a comment period.

Issue 07-4 Application of the Two-Class Method Under FASB Statement No. 128, *Earnings per Share*, to Master Limited Partnerships

STATUS: Tentative conclusion reached.

AFFECTS: Publicly traded master limited partnerships (MLPs) that issue incentive distribution rights (IDRs). This ownership structure is common in industries such as petroleum and natural gas extraction and transportation.

BACKGROUND: In a typical publicly traded MLP, cash is distributed to common units held by limited partners (LPs), a general partner (GP) interest, and IDRs in accordance with the terms specified in the partnership agreement.

Generally, the partnership agreement obligates the GP to distribute all of the partnership's available cash[3] at the end of each quarter to the LPs, GP, and when certain thresholds are met, the IDR holder. A complicating factor is that available cash distributions, as determined by the partnership agreement, may be based on terms different from earnings. Consequently, distributions may be in excess of earnings for any given period.

At issue is how current-period earnings of an MLP should be allocated to the IDR holder (a participating security) when the two-class method under Statement 128 is applied.

SUMMARY: **Earnings in Excess of Cash Distributions** — The Task Force reached a tentative conclusion that when current-period earnings are in excess of cash distributions, the undistributed earnings should be allocated to the GP, LPs, and IDR holder as if the undistributed earnings were available cash.[4] This reduces earnings per unit for the LPs and GP for entities that previously had considered the earnings-per-unit effect for an IDR to be limited to actual distributions to the IDR holder.

Cash Distributions in Excess of Earnings — When cash distributions are in excess of earnings, net income (or loss) would be reduced (or increased) by the actual distributions to the GP, LPs, and IDR holder. The resulting net loss would be allocated to the GP and LPs on the basis of their respective sharing of losses specified in the partnership agreement (provided that the IDR holder is not obligated to share in the losses of the partnership).

TRANSITION: A consensus would be effective for fiscal years beginning after December 15, 2007, and interim periods within those fiscal years, applied retrospectively for all financial statements presented. Early application would not be permitted.

NEXT STEPS: FASB ratification is expected at the Board's September 26, 2007, meeting, after which the tentative conclusion will be exposed for a comment period.

[3] "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 (1) operate the business (e.g., future capital expenditures); (2) comply with applicable law, debt, and other agreements; and (3) provide funds for distribution to the common unit, GP, and IDR holders for any one or more of the next four quarters.

[4] However, the IDR holder's share of undistributed earnings should not exceed any contractual cap.

Issue 07-5 Determining Whether an Instrument (or an Embedded Feature) Is Indexed to an Entity's Own Stock

STATUS: No decision reached.

AFFECTS: Entities with (a) options on their own shares (not within the scope of Statement 150[5]), (b) forward contracts to issue their own shares (including forward contracts entered into as part of an accelerated share repurchase program), and (c) issued convertible debt instruments and convertible preferred stock.

BACKGROUND: The instruments described above may contain contract terms that call into question whether the instrument or embedded feature is indexed to the entity's own stock. An instrument or embedded feature that is deemed indexed to an entity's own stock may be exempt from the requirements of Statement 133.[6] In addition, a freestanding nonderivative instrument that is indexed to a company's own stock remains eligible for equity classification under Issue 00-19.[7]

The Task Force has identified three general categories of instruments and embedded features as within the Issue's scope.

- **Category 1 Instruments** — For these instruments, **exercisability** is affected by one or more variables other than the entity's stock price, but such variables **do not** affect the settlement amount. Settlement is determined on the basis of a fixed number of shares for a fixed amount of consideration. An example is a warrant that permits the holder to buy 100 shares of the issuer's stock for a fixed amount of cash only if a contingent event occurs.
- **Category 2 Instruments** — The settlement amount is **always** affected by one or more variables other than the entity's stock price, or the party receiving shares may deliver noncash consideration whose value is affected by more than just the issuer's stock price. One example is a warrant to acquire a fixed number of the issuer's equity shares, with an exercise price denominated in a currency other than the issuer's functional currency.
- **Category 3 Instruments** — The settlement amount **may** be affected by one or more variables other than the entity's stock price, depending on the outcome of a contingent event or other condition. One example is a share-settleable forward contract to issue a fixed number of the entity's equity shares at a fixed strike price unless a contingent event (e.g., a change in control) occurs before the contractual settlement date. Once the contingent event occurs, the "calculation agent" may adjust the settlement amount on the basis of certain variables.

At issue is how an entity should determine whether Category 1, 2, and 3 instruments are indexed solely to its own stock.

SUMMARY: **Category 1** — Consistently with the existing consensus in Issue 01-6,[8] the Task Force preliminarily agreed that Category 1 instruments are considered solely indexed to an entity's own stock provided that their contingency provisions are **not** based on (a) an observable market, other than the market for the entity's stock, or (b) an observable index, other than those solely referenced to the entity's own operations.[9]

Category 2 — The Task Force discussed Category 2 instruments but did not reach any conclusion.

Category 3 — The Task Force preliminarily agreed that Category 3 instruments should be evaluated as if the contingent event were certain to occur. Therefore, Category 3 instruments would effectively be treated in the same manner as Category 2 instruments.

NEXT STEPS: The Task Force will form a working group to further analyze alternative approaches and develop a principle for how an entity should determine whether Category 2 instruments are solely indexed to its own stock. Further discussion is expected at the November 2007 EITF meeting.

[5] FASB Statement No. 150, *Accounting for Certain Financial Instruments With Characteristics of Both Liabilities and Equity*.
[6] FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities.*
[7] EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock."
[8] EITF Issue No. 01-6, "The Meaning of 'Indexed to a Company's Own Stock.'"
[9] For example, the entity's sales revenue; earnings before interest, taxes, depreciation, and amortization; net income; or total equity.

Issue 07-6 Accounting for the Sale of Real Estate When the Agreement Includes a Buy-Sell Clause

STATUS: Tentative conclusion reached.

AFFECTS: Entities (investors) that transfer real estate to a venture that they jointly own with another investor when the joint-ownership agreement contains a "buy-sell clause."

BACKGROUND: When two investors enter into an arrangement to create a jointly owned venture and one investor (the "selling investor") transfers real estate to that entity, the agreement commonly includes a buy-sell clause. A buy-sell clause permits either investor (the "offeror") in the jointly owned entity to irrevocably request a buyout of the other investor's (the "offeree's") entire interest by providing a notice (the "purchase notice") to the other investor.

In the purchase notice, the offeror typically names a price for the offeree's equity at its discretion. After receiving the purchase notice, the offeree **must** either sell its entire interest in the venture to the offeror or buy the offeror's interest at the named price. This example is known as an "unspecified-price" buy-sell clause. Other, less common, types of buy-sell clauses exist.

At issue is whether a buy-sell clause represents a prohibited form of continuing involvement (e.g., an option to reacquire the real estate) under Statement 66[10] that precludes partial sale-and-profit recognition upon transfer of the real estate to the venture by the selling investor.

SUMMARY: The Task Force reached a tentative conclusion that the selling investor should determine whether a buy-sell clause constitutes an option or other form of prohibited continuing involvement by considering facts and circumstances such as the following:

- Those that might effectively compel the buyer to sell its interest, such as prohibitions on the buyer's ownership of real estate or its lack of financial wherewithal to counter with a purchase offer.
- Those that might effectively compel the selling investor to reacquire the real estate, such as negative tax implications, favorable arrangements with the venture, or strategic needs to own the property.
- Others, such as certain fixed-price buy-sell clauses.

TRANSITION: A consensus would be effective for fiscal years beginning after December 15, 2007, and interim periods within those fiscal years, applied prospectively to transactions entered into after the effective date. Early application would not be permitted.

NEXT STEPS: FASB ratification is expected at the Board's September 26, 2007, meeting, after which the tentative conclusion will be exposed for a comment period.

[10] FASB Statement No. 66, *Accounting for Sales of Real Estate*.

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