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Accounting

Tentative Conclusions Reached on Three EITF Issues

At its September 11, 2007, meeting, the Emerging Issues Task Force (EITF) reached tentative conclusions on the following EITF Issues:

- *EITF Issue No. 07-01, "Accounting for Collaborative Arrangements"*

In several industries (e.g., the biotechnology, pharmaceutical, and motion picture industries), entities often enter into collaborative arrangements to share costs and revenues such as those related to research and development activities and commercialization of the resulting product. This Issue addresses the accounting for shared costs and revenues in collaborative arrangements in which a separate legal entity is not created. It should be noted that a collaborative arrangement falls within the scope of this issue only if the parties are actively involved and are exposed to significant risks and rewards that are tied to the commercial success of the endeavor.

In this Issue, a tentative conclusion was reached that costs incurred and revenue recognized on sales to third parties should be reported by each party based on the guidance in EITF Issue 99-19, "Reporting Revenue Gross as a Principal versus Net as an Agent." Payments *between parties to the collaborative arrangement* should be reported based on the nature of the arrangement and its contractual terms, the nature of each entity's business, and whether there are any existing generally accepted accounting principles that should be applied. The tentative conclusion also requires the parties to disclose certain information in their annual financial statements. If finalized, the guidance in this Issue would be effective in the first annual reporting period beginning after December 15, 2007.

- *EITF Issue No. 07-04, "Application of the Two-Class Method under FASB Statement No. 128, 'Earnings per Share,' to Master Limited Partnerships"*

Master limited partnerships (MLPs) often issue multiple classes of securities that participate in partnership distributions based on a formula. A typical MLP consists of a general partner interest (GP), publicly traded limited partner units (LPs), and incentive distribution rights (IDRs). IDRs are a type of limited partner interest; however, they are nonvoting interests that do not represent ownership in the MLP. The Task Force reached a tentative conclusion that this Issue would be applicable to all MLP arrangements regardless of whether the IDRs are a separate interest or embedded in the GP interest.

When the IDRs are a separate LP interest, the IDRs would represent a participating security and therefore the MLP would allocate current period earnings to the LP, GP, and IDR holder using the two-class method. When current-period earnings are in excess of cash distributions, undistributed earnings should be allocated to the GP, LPs, and IDR holder as if the undistributed earnings were available cash. When cash distributions are in excess of current-period earnings, net income (or loss) should be reduced (or increased) by distributions to the GP, LPs, and IDR holder. The resulting hypothetical loss would be allocated to the GP and LPs based on their respective sharing of losses specified in the partnership agreement. This tentative conclusion assumes that the IDR holder does not have a contractual obligation to share in the losses of the MLP.

When the IDR is embedded in the GP interest, the IDR would not be considered a participating security; however, the MLP would still apply the two-class method to the interests of the GP and LPs (although the GP's earnings allocation would include the rights of the IDR). Undistributed earnings should be allocated to the GP (including the distribution rights of the embedded IDR) and LPs as if the undistributed earnings were available cash. When the IDR is embedded in the GP interest, net income (or loss) should be reduced (or increased) by distributions to the GP (including the distribution rights of the embedded IDR) and LPs. The resulting hypothetical loss would be allocated to the GP and LPs based on their respective sharing of losses specified in the partnership agreement.

If finalized, the guidance in this Issue would be effective in the first fiscal year beginning after December 15, 2007, including the interim periods within that fiscal year.

- *EITF Issue No. 07-06, "Accounting for the Sale of Real Estate When the Agreement Includes a Buy-Sell Clause"*

A buy-sell clause is often included in an arrangement whereby two investors create a jointly-owned entity, and one of the investors sells real estate to the jointly-owned entity. The buy-sell clause allows either of the two investors to make an offer to buy-out the other investor's interest in the joint venture. A buy-sell clause in an arrangement that also includes the sale of real estate raises a question as to whether such a clause constitutes an option or other prohibited form of continuing involvement that would preclude partial sale and profit recognition by the investor that sold real estate to the jointly-owned entity. This Issue concludes that each such situation should be evaluated based on the specific facts and circumstances in which a buy-sell clause is involved. If finalized, the guidance in this Issue would be effective in the first fiscal year beginning after December 15, 2007, including the interim periods within that fiscal year.

Auditing

COSO Issues Discussion Document

According to the Committee of Sponsoring Organizations of the Treadway Commission (COSO), internal control over financial reporting can be viewed as consisting of five interrelated components, which serve as the criteria for determining whether internal control is effective. The five components described by COSO are:

- Control environment
- Risk assessment
- Control activities
- Information and communication
- Monitoring

Recently COSO has focused on issuing guidance about the monitoring component of internal control because it believes that monitoring has often been underutilized by organizations of all sizes. COSO has issued a discussion document, which is designed to further develop the understanding of effective monitoring so that organizations can recognize and properly utilize effective monitoring where it exists, and implement effective monitoring where it is needed. The document discusses three primary elements of monitoring that influence its effectiveness and efficiency:

- The control environment in which monitoring operates;
- The organization's ability to prioritize effective monitoring procedures and devote monitoring resources commensurate with the underlying level of risk; and
- The organization's communication structure and its ability to report results of monitoring, including control weaknesses, to the right people in a timely manner.

The document is the first phase of the broader COSO monitoring project, which is intended to improve the understanding of the building blocks of effective monitoring, thereby improving both the efficiency and the effectiveness of the entire system of internal control. The second phase of the monitoring project, scheduled for release after comments are received on the current discussion document, will provide examples, case studies, and tools to assist all organizations in implementing effective and efficient monitoring. COSO intends to release an exposure draft of the full implementation guidance later this year and intends to release the final guidance in the first quarter of 2008.

The discussion document related to the first phase of the COSO monitoring project is available for comment until October 31, 2007 at http://www.coso.org/Publications/COSO_Monitoring_discussiondoc.pdf.

SEC

SEC Revises FAQs on Internal Control

On September 24, 2007, the SEC posted a revised version of its *Management's Report on Internal Control Over Financial Reporting and Disclosure in Exchange Act Periodic Reports Frequently Asked Questions*. The FAQ was revised to eliminate 12 frequently asked questions that the staffs of the Office of the Chief Accountant and the Division of Corporation Finance believed were no longer necessary or were addressed by the SEC's issuance of Interpretive Guidance for Management on May 23, 2007, (Release No. 33-8810). Also, the SEC added four frequently asked questions related to foreign private issuers. The revised FAQ is available in full at <http://www.sec.gov/info/accountants/controlfaq.htm>. The answers to these questions are not the rules of the SEC, but may be useful to registrants in the implementation and interpretation of the rules.

International

Proposed Accounting for Joint Arrangements

The International Accounting Standards Board (IASB) has published for public comment Exposure Draft (ED) 9 proposing to replace International Accounting Standard (IAS) 31, *Interests in Joint Ventures*, with a new standard to be titled Joint Arrangements. Under IAS 31, a joint arrangement is a contractual arrangement whereby two or more parties undertake an economic activity together and share decision-making relating to that activity. Joint arrangements include joint assets, joint operations, and joint ventures. The main focus of the proposal is on two aspects of the current accounting for joint arrangements that the IASB considers to impede high-quality reporting. First, the current international accounting guidance for joint arrangements follows the legal form of the activities taken and does not always reflect the contractual rights and obligations agreed to by the parties. Second, the existing standard gives preparers a choice when accounting for interests in jointly controlled entities (equity method and proportionate consolidation), making it difficult to compare financial reports.

ED 9 proposes to shift the focus of accounting for joint arrangements to the contractual rights and obligations agreed to by the parties and to require parties to recognize both the individual assets to which they have rights and the liabilities for which they are responsible, even if the joint arrangement operates in a separate legal entity. If the parties only have a right to a share of the outcome of the activities, their net interest in the arrangement will be recognized using the equity method. Further, the proposal will require more disclosures about the operations an entity conducts through joint arrangements, including a description of the nature of joint arrangements and summarized financial information relating to its interests in joint ventures.

For the majority of entities, the proposed new standard is unlikely to reshape their balance sheet. This is because in most circumstances accounting for individual assets and liabilities gives the same outcome as proportionate consolidation. Therefore, if an entity has rights to individual assets and responsibility for liabilities (and related revenue and expenses) of a joint arrangement, the new standard will have little effect on its financial statements if that joint arrangement is not a legal entity or if it is a legal entity that was previously accounted for using proportionate

consolidation. In a similar manner, if an entity has rights only to a share of the outcome of the activities of a joint arrangement, there will be little change if that joint arrangement is a legal entity and was previously accounted for using the equity method. The proposed new standard will cause more significant changes for entities that have been using proportionate consolidation and are recognizing assets and liabilities in their financial statements even though they have no rights to the assets or responsibility for the liabilities, and for those entities that have rights to assets and responsibility for liabilities but are not recognizing those rights and responsibilities because they are using the equity method of accounting.

ED 9 will be available for comment until January 11, 2008, at www.iasb.org/Home.htm

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