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Introduction

Over the past couple of decades, master limited partnerships (MLPs) helped fuel growth in the oil and gas sector. Midstream pipeline operators have long dominated the energy MLP subsector, but other types of operations have also been put into MLP structures, including upstream exploration and production, drilling and other oil field services, gathering and processing, propane and refined product distribution, and coal production and shipping.

While the number of MLPs has declined in recent years due to consolidation and conversions to corporate status for US federal income tax purposes, many MLPs still exist, mainly in the midstream sector.

From an accounting and reporting perspective, each MLP has its own set of complexities. No two MLPs are exactly alike. They each consist of a group of assets with their own unique history and set of issues, their own governance and their own legal structure.

As with any business transaction, forming an MLP requires careful research and planning. By giving early consideration to such complexities in the planning stages, companies can accelerate the MLP formation process, reduce costs and enhance the overall value of the MLP structure.

In this Master limited partnership accounting and reporting guide, we discuss a variety of common accounting and reporting considerations associated with the formation and ongoing operations of an MLP. The guide is designed to help companies understand the accounting and reporting issues associated with an MLP and the related authoritative guidance. However, it is not intended to be a substitute for detailed research or the exercise of professional judgment on all issues related to an MLP. We hope you find this publication useful.
What is an MLP?

An MLP is a limited partnership whose limited partnership units are available to investors and traded on public exchanges, just like corporate stock.\(^1\) MLPs usually have (1) a general partner (GP), who typically holds a small percentage (commonly 0–2%) of the outstanding partnership units and manages the operations of the partnership and (2) limited partners (LPs), who provide capital and hold most of the ownership but have limited influence over the operations.

Energy companies form MLPs for a variety of reasons, including the ability to access public capital or to provide for a partial exit strategy for the MLP sponsor. Additionally, MLPs may be formed to take advantage of the single-level of taxation that occurs as a result of the MLP being classified as a partnership for US federal income tax purposes. So long as the MLP meets the “qualifying income” requirements, MLPs do not pay US federal income taxes. Instead, each partner includes its distributive share of income, gain, loss, deduction and credit when computing its US federal income tax. Distributions of cash from the MLP to the partners are not subject to US federal income tax at the time of distribution (although many MLPs withhold taxes on cash distributions to non-US investors). This process often allows an MLP to avoid the double taxation generally applied to traditional corporations and their shareholders, resulting in higher cash flow and a lower cost of capital.

For a publicly traded MLP to be treated as a partnership for US federal income tax purposes, at least 90% of an MLP’s gross income must consist of “qualifying income” (e.g., income derived from certain natural resource related activities, as well as certain other activities).\(^2\)

An MLP structure typically allows the GP to make decisions on behalf of the MLP including its publicly traded common and subordinated interests (referred to collectively as LP interests or LP units throughout). The LPs’ ability to make decisions may be limited, even when a majority LP interest in the MLP is held by the public. This lets a sponsor entity take advantage of an MLP’s potentially lower cost of capital while often retaining a controlling financial interest in the partnership’s assets and operations.

The MLP business model is built around generating and distributing cash flows on a quarterly basis. Cash is generated and used to make debt payments, fund growth through the acquisition of assets to generate additional cash, maintain the asset base and sustain the operating cash flow generating capability. The MLP’s excess cash (which is defined in most MLP partnerships agreements as “available cash”) is distributed to the GP and LPs in order to meet required minimum quarterly distributions. The GP (and, in limited circumstances, other investors) may separately hold incentive distribution rights (IDRs) that allow such investors to participate in cash distributions when the distribution to LPs exceeds certain levels. Holding IDRs encourages the GP to grow the MLP business and increase distributions to all investors.

In recent years, however, the market’s appetite for IDRs has declined. As a result, many MLPs that had IDRs converted those interests into common units or took other steps to simplify their structure and eliminate IDRs.

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\(^1\) The term MLP often encompasses both a “traditional” MLP and a “variable” MLP. For purposes of this article, the term “MLP” refers to the “traditional” MLP format, which is often a limited partnership (with a general partner and limited partners) that provides for minimum quarterly distributions to holders of common units and often has incentive distribution rights (often held by the general partner). The variable MLP format is typically a limited liability company that is taxed as a partnership for US federal income tax purposes. As a general matter, the variable MLPs have neither incentive distribution rights nor minimum quarterly distributions, with one class of interests (at least upon formation).

\(^2\) At the time of this publication, to maintain treatment as a partnership, at least 90% of the MLP’s gross income must consist of “qualifying income,” which is defined by the Internal Revenue Code § 7704.
Upon formation, a typical MLP has historically had four types of interests: (1) the GP interest (which is often held by the sponsor); (2) the IDR interest (although, as discussed above, many IDR structures have recently been simplified to eliminate the IDR interest); (3) subordinated units (which earn a residual interest, are often held by the sponsor and are initially not publicly traded, although they may convert to common units as a result of meeting certain time or performance thresholds); and (4) common units (which may have a preferred return), which are sold (in whole or in part) to the public in connection with the initial public offering (IPO).

MLP structures have historically focused on energy-related assets (e.g., pipelines, oil field service equipment, wells) with steady growth potential and high cash flow, which lend themselves to an MLP’s objective of increasing cash distributions to unit holders. Other subsets of the energy industry, such as natural gas processing plants, coal production facilities and fully developed and slowly declining crude oil or natural gas producing assets, have also utilized the MLP structure.

As discussed earlier, certain MLPs focusing on upstream, downstream and ancillary businesses, have moved away from an MLP structure, and certain midstream MLPs have either consolidated or converted to corporate status for US federal income tax purposes.

Preparing for formation of an MLP

As a plan to form a publicly traded MLP begins to materialize, identifying and addressing the accounting and reporting requirements becomes a key objective. Launching a publicly traded MLP can involve a considerable amount of organizational planning, technical research and an extensive process of collecting and preparing historical, and forecasted, financial information. The level of effort necessary to execute the plan should not be underestimated.

One of the early determinations that must be made is the form, content and level of any financial statements that the MLP would need to provide in a registration statement filed with the Securities and Exchange Commission (SEC). This may require obtaining audited financial statements for an entity or business for the first time. When an MLP with minimal historical operations will succeed to the operations of another entity or group of entities, a predecessor must be identified for purposes of preparing historical financial statements. The historical financial statements of a predecessor may comprise financial statements of an existing entity or carve-out financial statements from a larger existing company. Carve-out financial statements generally represent financial statements of a business, such as a division or a lower-level subset of businesses (e.g., a group of proved properties) within a larger entity. That is, financial information of an acquired or contributed business may need to be carved out of the larger entity. See the “Predecessor financial information” subsection of this publication for additional accounting and financial reporting considerations for determining which entity is the predecessor.

Companies should consider whether they need to seek pre-clearance from the SEC staff on complex reporting issues related to the financial information to be included in the IPO registration statement, including the issues described above. Obtaining pre-clearance from the SEC’s Office of the Chief Accountant (for accounting related matters) or the Division of Corporation Finance (for reporting and filing related matters) can help address and resolve issues up front, potentially avoiding the costly and time consuming process of redrafting financial statements and pro forma financial information following the SEC’s Division of Corporation Finance staff review, which could delay the offering.

As entities prepare the historical financial statements and registration statement, they should plan for the changes that will occur at or near the time of the IPO. For example, corporations earmarked for inclusion in the MLP will be required to change to nontaxable entities (limited liability companies or partnerships). Some entities also obtain Internal Revenue Service private letter rulings to verify that the potential MLP’s activities meet qualifying income requirements.

Individuals responsible for overseeing the MLP formation and SEC registration process should also consider how a number of other matters will be addressed, such as how to account for shared services and allocated expenses, including interest expense, in the historical financial statements.

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3 For more information about the preclearance process, see “Contacting the staff for advice” on the SEC website at [https://www.sec.gov/divisions/corpfin/cfreportingguidance.shtml](https://www.sec.gov/divisions/corpfin/cfreportingguidance.shtml).
Following its IPO, the MLP will be engaged in ongoing management processes involving corporate governance, reporting, regulations and other public company responsibilities. As a result, a sponsor entity will need to plan for the accounting and reporting requirements of a public company, including those related to implementing and maintaining its internal control over financial reporting.

The MLP will also have additional accounting issues related to the presentation of multiple classes of equity (e.g., GP units, LP units and IDRs), allocation of earnings to these equity classes and earnings per unit (EPU) calculations on multiple classes of units.

Typically, an MLP’s primary objective is to maintain or increase cash distributions to investors. Another objective in many cases is to build on its existing asset portfolio. Whether this is accomplished through organic growth (achieved by investing cash inflows into property, plant and equipment), acquisition of additional businesses, or contributions of assets from the sponsor entity, further deal execution and assimilation of the growing business into the MLP organization will be necessary.

Put simply, once formed, the MLP’s reporting will have additional complexity.

In addition to the accounting challenges at the MLP level, a sponsor will face additional issues related to the IPO and ongoing financial reporting for its investment in the MLP. Thus, sponsors planning to launch an MLP will want to analyze and forecast the accounting ramifications of the interests in the GP and the MLP to their financial statements. Consolidation and the related accounting for noncontrolling interests, as well as other issues detailed later in this publication, are common issues the sponsor entity may need to consider.

When evaluating and planning the formation of or investment in an MLP, a company must keep in mind that its significant accounting decisions will depend heavily on the facts and circumstances. Sound knowledge of accounting and reporting guidance, including SEC reporting requirements, is necessary for MLPs and their sponsor entities to be prepared to go to market and reduce obstacles along the way.

Accounting and reporting by MLPs

This section provides an overview of the financial accounting and reporting issues and authoritative guidance that may be applicable to the preparation of financial statements for inclusion in a registration statement of an MLP during its formation and IPO as well as certain accounting and reporting issues associated with an MLP’s periodic reporting following its initial registration statement.

Predecessor financial information

The MLP’s historical financial statements (also referred to as the predecessor financial statements) must be included in its initial registration statement (generally Form S-1) for the MLP’s units to be offered to the public and for the MLP to list as a publicly traded limited partnership (i.e., an SEC registrant). The entity(ies) or group of assets included in the predecessor financial statements is also referred to, throughout, as the predecessor entity.

The historical financial statements of the predecessor entity presented in Form S-1 must comply with the SEC’s Regulation S-X. Predecessor financial statements are required because they represent the past operating performance of the assets forming the MLP that allows financial statement users to evaluate the historical operating performance and future prospects of the MLP.

If an MLP is formed from a combination of entities or subsets of entities, a decision must be made about which of the entities is the predecessor. The predecessor’s financial statements must also comply with Regulation S-X and be included in the initial registration statement. The term “predecessor” is defined in Rule 405 of the SEC’s Regulation C as “a person the major portion of the business and assets of which another person acquired in a single succession, or in a series of related successions in each of which the acquiring person acquired the major portion of the business and the assets of the acquired person.”
If an MLP is formed by combining entities that are under common control and were acquired at different times during the periods presented in the financial statements, the SEC staff has indicated that the predecessor may be the entity that was first controlled by the parent of the entities that are going to be combined (dropped down) into the MLP. It’s possible that an MLP may have multiple predecessors, but this conclusion is rare. If the timing of the acquisition of the entities is not determinative, an entity should consider various factors, such as:

- The relative size of the entities
- Management and governance of the ongoing registrant
- Whether the entities comprise substantially all of a common seller’s division or reportable segment

Predecessor financial statements are required to comply with Regulation S-X Rules 3-01 and 3-02 like any other registrant, which require full financial statements for all periods. However, given that a predecessor is not an “issuer” as defined by the PCAOB, the audit must be conducted in accordance with both PCAOB and AICPA standards and the audit report must refer to both. That is, the predecessor financial statements are not eligible for any relief that would apply to the financial statements of a significant acquiree under Regulation S-X Rule 3-05 (Rule 3-05). Additional considerations relating to the formation of an MLP by the merger of entities under common control are discussed in the sub-section “Financial statements of entities under common control” below.

The MLP’s initial registration statement must include the following (audited and unaudited) predecessor financial statements:

- Audited balance sheets as of the end of each of the past two fiscal years
- Audited statements of comprehensive income, cash flows and owners’ equity for each of the past three fiscal years (see subsection “Emerging growth company eligibility” below for possible exception)
- Unaudited financial statements as of and through the most recent interim period (together with comparative statements for the corresponding period of the preceding fiscal year). These interim statements are required if the registration statement is filed or declared “effective” 135 days or more after the end of a fiscal year.

Selected financial data, management’s discussion and analysis (MD&A) and other nonfinancial requirements of Regulation S-K must also be provided in the MLP’s initial registration statement.

In addition to consolidated financial statements of both the new registrant and its predecessor, other financial statements are often required in initial registration statements. These could include financial statements of businesses acquired or to be acquired under Rule 3-05 or investments accounted for under the equity method (Regulation S-X, Rule 3-09 (Rule 3-09)).

Providing financial statements or financial information for these other entities may continue once an MLP goes public (i.e., becomes an SEC registrant). The financial statements of significant investees under Rule 3-09 must be provided in the MLP’s annual reports on Form 10-K. If an MLP issues registered debt securities after its IPO that are guaranteed or collateralized by an affiliate’s stock, the MLP must consider if there is a requirement to provide financial statements of significant affiliates under Rule 3-16 of Regulation S-X (Rule 3-16), and subsidiary issues or guarantors under Rule 3-10 of Regulation S-X (Rule 3-10), assuming relief isn’t available under Rule 3-10.

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5 Requirements may differ for smaller reporting companies (see Regulation S-K Item 10(f) to determine eligibility). Also see “Emerging growth company eligibility” section below for further requirements.
In the Master Glossary of the Accounting Standards Codification (ASC), the Financial Accounting Standards Board (FASB) defines a public business entity (PBE) as a business entity that meets any one of several criteria including one that states, “It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).” Based on this definition, the MLP, each of its predecessor(s) and any other entity whose financial statements are furnished or filed (e.g., Rule 3-05, Rule 3-09, Rule 3-16, Rule 3-10) would be considered PBEs and would therefore be required to apply any generally accepted accounting principles (GAAP) requirements (including effective dates) for PBEs.6

Financial statements of entities under common control

An MLP may be formed through a combination of entities under common control of the sponsor entity. If the combination occurred during the historical periods presented, the historical financial statements in the initial registration statement should give retroactive effect to the merger of the entities for the periods in which they were under common control. For periods before the entities became under common control, the financial statements presented are those of the combining entity that is determined to be the predecessor (which is generally the entity that was first controlled by the sponsor entity). If the entities under common control combine after the date of the latest financial statements included in the initial registration statement but before the initial registration statement’s effective date, the SEC staff allows the presentation of combined financial statements of the merged entities.7

If the combination of the entities under common control will not occur until after the effective date of the initial registration statement (e.g., the merger is a condition to the closing of the IPO), the SEC staff has stated that separate historical financial statements of the entities to be combined should be presented, and the merger should be reflected only in the pro forma financial information. In this situation, the SEC staff has said it will consider requests to present combined financial statements as the primary financial statements of the registrant instead of separate financial statements based on a registrant’s individual facts and circumstances. The SEC staff also indicated that it would consider requests for relief to use combined financial amounts as the denominator for purposes of significance calculations used in determining other financial statement requirements for the filing (for example, Rules 3-05 and 3-09).8

Predecessor spin-off of a business

In certain situations, a subsidiary being contributed to the MLP by its sponsor entity may distribute a business to the sponsor entity prior to that subsidiary being contributed to the MLP (e.g., because it has income from non-qualifying activities). Since the distribution typically occurs simultaneously with the IPO transaction, the historical financial statements of the predecessor included in the initial registration statement generally should include the operations of the distributed business. SEC Staff Accounting Bulletin (SAB) Topic 5.Z.7, Accounting for the Spin-off of a Subsidiary (SAB Topic 5.Z.7), provides guidance on the limited circumstances under which the distributed business may be excluded from the subsidiary’s historical financial statements that will appear in the MLP’s initial registration statement. Generally, a subsidiary will be required to account for the disposition under ASC 505-60, Equity — Spinoffs and Reverse Spinoffs; ASC 360, Property, Plant, and Equipment; and ASC 205-10, Presentation of Financial Statements — Overall, at the time of the transaction and provide appropriate pro forma financial information.

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6 With ASU 2019-10, the FASB created a “two-bucket approach” for adopting major accounting standards in which SEC filers other than smaller reporting companies adopt a major new accounting standard at least two years before all other entities. However, because public business entities (PBE’s) have already adopted the improvements to the hedge accounting guidance and the new leases standard, the FASB deferred the effective dates for those standards only for entities that have not yet adopted them. That includes emerging growth companies that use private company effective dates, and based on SEC staff guidance, entities that are PBEs solely because their financial statements are included in another entity’s SEC filing, such as in accordance with S-X Rules 3-06 or 3-09.


8 Financial Reporting Manual (FRM) Section 13410.3, Change in the reporting entity or a business combination accounted for in a manner similar to a pooling of interest
Financial information of the GP in limited partnership offerings

SAB 113 rescinded SAB Topic 12.A.3.d, *Oil and Gas Producing Activities*, which had required a GP balance sheet in the registration statement of oil and gas producing limited partnerships. However, Regulation S-X Rule 8-07 (Rule 8-07) still requires certain balance sheet information about a GP to be presented in the registration statement of a limited partnership.

Article 8 of Regulation S-X applies to financial statements filed for smaller reporting companies; therefore, an MLP that is a smaller reporting company should comply with this rule or, if it believes that there is a basis for relief, submit a waiver request in writing to the staff in the SEC’s Division of Corporation Finance. The Division’s Financial Reporting Manual (FRM) clarifies that oil and gas companies, other than smaller reporting companies, can rely on SAB 113 and do not need to request the SEC staff’s approval to exclude the balance sheet of the GP.9

There may be situations in which registrants should disclose the following information about the relationship between the GP and the limited partnership10, 11:

- When there are material transactions with the GP, such as substantial receivables from or payables to a GP, or any affiliate of the GP, disclose the relevant terms of any material transactions
- When there is a commitment, intent or reasonable possibility that the GP(s) will fund cash flow deficits or provide other direct or indirect financial assistance to the registrant, describe the nature and extent of any funding or financial support arrangement
- When an affiliate of the GP has committed itself to increasing or maintaining the GP’s capital, if the commitment could reasonably be expected to affect the registrant, describe the nature and extent of the affiliate’s commitment to the GP including, for example, when an affiliate has committed to maintain the GP’s capital when there is a commitment, intent or reasonable possibility that the GP will provide financial support to the registrant

These disclosure requirements may be in addition to those under other relevant US GAAP (e.g., disclosures under ASC 850, *Related Party Disclosures*; ASC 810, *Consolidation*; ASC 440, *Commitments*; ASC 460, *Guarantees*).

Emerging growth company eligibility

The JumpStart Our Business Startups Act (JOBS Act) of 2012 created the category of issuer called an emerging growth company (EGC) and provided EGCs with certain regulatory relief for their initial registration statements and for a five-year “IPO on-ramp” period.

Generally, a company qualifies as an EGC if its total annual gross revenues are less than $1.07 billion in its most recently completed fiscal year. The SEC staff has said that EGC eligibility could apply to a wholly owned subsidiary that is spun-off from its parent.12

In its initial registration statement, an EGC may take advantage of certain relief, including providing:

- Two years of audited financial statements, selected financial data and MD&A in the initial registration statement (including other entity financial statements)
- Scaled executive compensation disclosures (also applies to an EGC’s periodic filings during the IPO on-ramp period)
- Ability to follow private company effective dates for new or revised accounting standards

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9 FRM Section 2805 *General Partner, Where Registrant is a Limited Partnership*.
10 Ibid.
11 Requirements may differ for smaller reporting companies (see Regulation S-K Item 10(f) to determine eligibility).
Carve-out financial statements

Carve-out financial statements generally represent financial statements of a business, such as subsidiaries, divisions or other components of a business (e.g., a group of proved properties), within a larger entity. The preparation of such financial statements requires care in identifying all the assets and liabilities of the business, regardless of whether those assets and liabilities are being contributed to the MLP. Furthermore, certain corporate expenses incurred by the parent entity, such as selling, general and administrative expenses, interest expense or income tax expense, may not have been specifically allocated to the business to be carved out in the past. The SEC staff expects carve-out financial statements to comply with the guidance in SAB Topic 1.B, Allocation of Expenses and Related Disclosure in Financial Statements of Subsidiaries, Divisions or Lesser Business Components of Another Entity (SAB Topic 1.B). See our publication, Guide to preparing carve-out financial statements, which provides considerations for entities when preparing carve-out financial statements.

Issuance costs

Companies often incur costs in connection with the issuance of equity securities. ASC 340-10-599-1 states that, prior to the effective date of an offering of equity securities, specific incremental costs directly attributable to a proposed or actual offering of securities may properly be deferred and charged against the gross proceeds of the offering. Such costs include legal fees, printing costs and bankers’ or underwriters’ fees. They also may include internal costs that meet the incremental and direct criteria such as travel costs directly related to financing. Costs such as salaries (and generally any other form of compensation), rent and other period costs, including other general and administrative costs, cannot be capitalized as issuance costs. In addition, ASC 340-10-599-1 states that deferred costs of an aborted offering may not be deferred and charged against proceeds of a subsequent offering. A short postponement (up to 90 days) does not represent an aborted offering.

Allocation of issuance costs

It is not uncommon for an MLP to issue both debt and equity in connection with its public offerings. If this occurs, the MLP will need to allocate the issuance costs incurred to debt and equity. The portion of issuance costs allocated to the debt should be presented on the balance sheet as a direct reduction to the carrying amount of the debt liability, and the costs should be amortized as interest expense over the life of the debt using the effective interest method. The portion of issuance costs allocated to the equity instruments should be recognized as a reduction to the proceeds of the equity offering (i.e., a reduction to equity). There is no authoritative literature that provides guidance on how issuance costs should be allocated.

We generally believe that the issuer should adopt a systematic and rational allocation approach based on the facts and circumstances and apply that approach consistently. For example, assume the MLP is issuing $125 million in notes and is also issuing $125 million in partnership interests. The issuer could, for example, allocate the offering costs based on the relative costs of separately issuing debt and equity. Assume that the total offering costs were $4 million, and the typical costs associated with similar debt is one percent of the issuing amount, while the typical offering costs for common stock are 3% of the offering amount. In that case, the issuer might allocate one-quarter of the costs, or $1 million, to debt issuance costs and three-quarters of the costs, or $3 million, to equity offering costs.

Accounting for contributed assets and liabilities

An MLP can be formed through a variety of transactions, including:

- Roll-up transaction – two or more legally separate limited partnerships are combined into one master limited partnership
- Dropdown transaction – a transfer of certain net assets from a sponsor or general partner to a master limited partnership in exchange for consideration
- Roll-out transaction – certain assets of a sponsor are placed into a limited partnership and units are distributed to the shareholders
- Reorganization – all of the assets of an entity are placed into a master limited partnership and that entity ceases to exist

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13 ASC 835-30-45-1A and ASC 835-30-35 through 35-3.
14 ASC 340-10-599-1.
One of the first accounting issues the MLP needs to address is whether it should recognize a new basis of accounting in the historical financial statements to be included in the registration statement for the assets and liabilities its sponsor entity has contributed. When an MLP is formed and the MLP remains under common control with the sponsor entity, a new basis of accounting is not appropriate for the assets and liabilities received from the sponsor entity (ASC 805-50-30-7).

**Entities under common control**

Some MLPs are formed or expanded when the sponsor entity transfers its ownership interest in a subsidiary to the MLP in exchange for an ownership interest in the MLP. This would be a reconsideration event under ASC 810, and the parties should determine which entity, if any, controls the MLP and the contributed subsidiary. See the “Consolidations considerations” subsection within the “Accounting and reporting by sponsor entities of MLPs” for additional guidance.

If it is determined that the entities are under common control, the parties should consider the guidance in ASC 805-50-30-5, which states the following:

“When accounting for a transfer of assets or exchange of shares between entities under common control, the entity that receives the net assets or the equity interests shall initially measure the recognized assets and liabilities transferred at their carrying amounts in the accounts of the transferring entity at the date of transfer. If the carrying amounts of the assets and liabilities transferred differ from the historical cost of the parent of the entities under common control, for example, because pushdown accounting had not been applied, then the financial statements of the receiving entity shall reflect the transferred assets and liabilities at the historical cost of the parent of the entities under common control.”

Therefore, the assets would be reflected in the historical financial statements of the MLP using the sponsor entity’s historical cost. If the MLP transfers cash to the GP in the exchange, any cash transferred in excess of the carrying value of the assets and liabilities transferred should be treated as a capital transaction (e.g., a distribution to the GP), which could lead to recognition of a deficit in the GP’s capital account. If the MLP issues partnership interests in the exchange, the partnership interests issued should be recorded at an amount equal to the carrying amount of the assets and liabilities transferred (at the historical cost of the sponsor entity), even if the fair value of the partnership interests issued is reliably determinable.

For example, if the sponsor entity transfers its ownership interest in a subsidiary (Sub B) to another subsidiary (MLP A) in exchange for an additional partnership interest of MLP A, and it is determined that the sponsor entity retains control of MLP A, which controls Sub B, then the transaction is appropriately accounted for as an exchange of shares between entities under common control. The consolidated financial statements of MLP A should reflect the historical cost of Sub B as it is reflected in the consolidated financial statements of the sponsor entity. We believe this also would be required when the sponsor entity transfers a noncontrolling interest in a subsidiary to the MLP that will be accounted for under the equity method by the MLP (e.g., the sponsor transfers a 20% ownership interest in Sub B to MLP A and the sponsor entity retains control of both entities). In this situation, the MLP would reflect 20% of the sponsor entity’s historical cost in Sub B.

When the contributed subsidiary meets the definition of a business in ASC 805, Business Combinations, but the MLP and sponsor entity are under common control, prior period financial statements of the transferee (i.e., the entity receiving the transferred operations, which in this case is the MLP) generally should be restated for all periods in which the transferred operations were part of the ultimate parent’s consolidated financial statements.

If an MLP and its sponsor entity are not under common control, an MLP must address whether the MLP should account for the contribution as a business combination under ASC 805. This will require a careful analysis of all facts and circumstances including the nature of the assets contributed.

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15 The assessment of common control may require the sponsor entity and MLP to apply the variable interest entity model or voting model in ASC 810 to evaluate which party (if any) controls the MLP.

16 If the MLP or a parent itself were acquired in a business combination by an entity not under common control, the MLP, as a subsidiary of the acquired entity, is allowed to apply pushdown accounting to its separate financial statements, regardless of whether the parent entity elects to apply pushdown accounting.
Common control transfers

In certain situations, a subsidiary may transfer a business to an MLP that is controlled by the same parent. For example, assume Subsidiary C (an SEC registrant) transfers Business B to an MLP; both Subsidiary C and the MLP are controlled by Parent A.

Prior period financial statements of the transferee (i.e., the entity receiving the transferred operations, which in this case is the MLP) generally should be restated for all periods in which the transferred operations were part of the ultimate parent’s consolidated financial statements.

The procedural guidance on the combination of entities under common control included in ASC 805-50 addresses the accounting only from the perspective of the receiving entity (the MLP in the above example). There is no specific guidance on how the transferring entity (Subsidiary C) accounts for transactions between entities under common control.

As a transaction between entities under common control does not result in a change in control at the ultimate parent level, a new basis of accounting is not recognized by the receiving entity. It is for similar reasons that we generally would expect that the transferring entity would not recognize a gain or loss on the transaction. Any difference between the proceeds received by the transferring entity and the book value of the asset group (after impairment, if any) would be recognized as an equity transaction (i.e., dividend or capital transaction) and no gain or loss would be recorded.17

However, the question arises about how the transferor’s prior period financial statements should be presented in transfers of entities under common control. The requirement of the receiving entity to restate prior period financial statements is based on the concept that there has been a change in the reporting entity. Generally, we do not believe that the transfer of net assets or the exchange of equity interests between entities under common control results in a change in the reporting entity of the transferring entity (even if the assets transferred or shares exchanged constitute a business). As such, we do not believe that retrospective adjustment of the prior period financial statements (in the standalone financial statements of the transferring entity) to reflect the removal of the transferred net assets at their carrying amount is appropriate in most circumstances.

While SAB Topic 5.Z.7 does not directly address a change in reporting entity in a common control transaction, we believe the criteria in the SAB are analogous to those that should be carefully considered when evaluating whether, from the transferring entity’s perspective, there has been a change in reporting entity in a common control transaction. All criteria in the topic must be met for the transferring entity to conclude that it has a change in reporting entity, and we have observed the SEC staff challenge a company’s assertion that it has met all requirements. Therefore, it is more common for the transferring entity to conclude that the criteria are not met and account for the transfer as a disposal pursuant to ASC 360-10, Plant, Property, and Equipment – Overall, and assess for discontinued operations reporting pursuant ASC 205-20, Presentation of Financial Statements – Discontinued Operations.

Issuance of units to a predecessor GP upon formation

In some new MLP formations, such as roll-ups, an existing MLP is contributed to a new MLP. When the GP of an existing MLP (predecessor GP) will not continue as the GP of the new MLP, the new MLP may issue units to the predecessor GP to settle existing management or other service contracts with the predecessor GP. The issuance of units in the new MLP to the predecessor GP to settle these contracts has the characteristics of compensation rather than those of an equity distribution and should be accounted for in accordance with ASC 718, Compensation – Stock Compensation, by the new MLP.

17 Depending on the legal form of the transaction, specific guidance may apply. For example, if the transferred business were first distributed to the Parent A and then contributed to MLP, consideration should be given as to whether the transaction is a spin-off that would be accounted for under ASC 505-60.
Sale and leaseback transactions after the adoption of ASC 842, Leases

MLPs and parent sponsors that engage in sale and leaseback transactions may reach different accounting conclusions after they adopt ASC 842, Leases, than they did under the legacy leasing guidance.

Under ASC 842, both seller-lessees (e.g., a parent/ sponsor) and buyer-lessees (e.g., an MLP) are required to apply ASC 842 and certain provisions of ASC 606, Revenue from Contracts with Customers, to determine whether to account for a sale and leaseback transaction as a sale (seller-lessee) and purchase (buyer-lessee) of an asset. If control of an underlying asset passes to the buyer-lessee, the transaction is accounted for as a sale (seller-lessee) or purchase (buyer-lessee) and a lease by both parties. If not, the transaction is accounted for as a financing by both parties.

ASC 606 provides guidance that should be applied to determine whether control of an underlying asset passes to the buyer-lessee, and ASC 842-40-25-2 through 25-3 provides guidance that states that a buyer-lessee is not considered to have obtained control of the asset if the leaseback would be classified as a finance lease (seller-lessee) or sales-type lease (buyer-lessee). Also, note that sale and leaseback transactions among entities under common control are subject to ASC 842-40’s sale and leaseback guidance.

Oil and gas entities, particularly those with midstream and downstream activities, have historically considered ASC 840’s real-estate specific guidance to determine the classification of leases of land, buildings and integral equipment. Because the new standard eliminates that guidance, these entities follow the same classification guidance for leases of all assets.

ASC 842 also introduces a new classification criterion. A lease is classified as a finance lease by a lessee and a sales-type lease by a lessor if the underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

We expect these changes to result in MLPs and sponsor entities accounting for certain transactions they previously accounted for as sale and leaseback transactions as financings (i.e., failed sales).

Other resources

Financial reporting developments, Business combinations, Appendix C: Accounting for common control transactions
Financial reporting developments, Discontinued operations
Financial reporting developments, Consolidation: Determination of a controlling financial interest and accounting for changes in ownership interests
Financial reporting developments, Lease accounting: Accounting Standards Codification 842, Leases
Guide to preparing carve-out financial statements

Businesses acquired or to be acquired

If the MLP itself or an entity being contributed to an MLP has had a recent acquisition or if an acquisition is probable, the audited financial statements of the business acquired or to be acquired may be required in the initial registration statement under Rule 3-05. MLPs will also need to consider the requirements of Rule 3-05 to comply with Form 8-K’s periodic reporting requirements for significant businesses acquired after initial registration of the MLP.

The determination of what constitutes a business for SEC reporting purposes differs from what constitutes a business for accounting purposes, which could result in an entity accounting for a transaction as an asset acquisition under US GAAP and as an acquisition of a business under Rule 3-05.

The definition of a business for reporting purposes in Regulation S-X Rule 11-01(d), Presentation Requirements (Rule 11-01(d)), presumes that a separate entity, a subsidiary or a division is a business. The definition also notes that a lesser component of an entity may also constitute a business as defined by Regulation S-X. Facts and circumstances should be considered in evaluating whether an acquisition of a lesser component of an entity constitutes a business. Rule 11-01(d) specifically identifies certain circumstances that may indicate that a lesser component is a business, including whether (1) the nature of the revenue-producing activity of the component will generally remain the same as before the transaction or (2) certain attributes remain with the component after the transaction.
Registrants must measure the significance of an acquired business under Rule 3-05 using three tests:

- Asset test — compare the registrant’s share of the acquired business’s total assets to the registrant’s consolidated total assets
- Investment test — compare the total US GAAP purchase price of the acquired business to the registrant’s consolidated total assets
- Income test — compare the registrant’s pro rata share of the acquired business’s income from continuing operations before taxes (net of noncontrolling interest) to that of the registrant

Table 1 in Appendix B details the financial statement requirements in Rule 3-05 for completed business acquisitions (not falling into the 75-day period for registration and proxy statements noted below) based on these tests.

Financial statements of acquired businesses are required as follows (excerpted from the FRM Section 2040.1).

Registration statements and proxies

If less than or equal to 50% significant, financial statements of a recent or probable acquisition need not be included unless the registration statement (or post-effective amendment) is declared effective (or proxy statement is mailed) 75 days or more after the acquisition is consummated.

If significance exceeds 50%, financial statements of a recent or probable acquisition must be included in a registration statement (or post-effective amendment) at the effective date.

Form 8-K

Reporting the transaction is required within 4 business days of the consummation of any business acquisition exceeding 20% significance or for any asset purchase exceeding 10% significance that does not meet the definition of a business.

If the required financial statements of the business acquired are not available to be provided with the initial report, they must be filed by amendment within 71 calendar days after the date that the initial report on Form 8-K must be filed.

While an Item 2.01 Form 8-K is not required for business acquisitions at or below 20% significance, registrants may elect to report business acquisitions at or below 20% significance pursuant to Item 8.01 of Form 8-K even if financial information is not provided.

SAB Topic 1.J, Application Of Rule 3-05 In Initial Public Offerings (SAB Topic 1.J), is an interpretation of Rule 3-05 and is applicable for certain initial registration statements involving businesses that have been built by the aggregation of discrete businesses that remain substantially intact after acquisition (e.g., the acquired businesses have not been altered by post-acquisition decisions as to the allocation of incoming orders between locations or entities).

SAB Topic 1.J is intended to be applied in situations in which an acquired entity may be better measured in relation to the size of the registrant at the time the registration statement is filed (i.e., based on pro forma financial information including probable acquisitions). It makes sure that the registration statement will include not less than one, two and three year(s) of audited financial statements for not less than 60%, 80% and 90%, respectively, of the constituent businesses that the registrant will comprise on an ongoing basis.

If the aggregate of the asset, investment or income significance test of all insignificant acquisitions exceeds 50%, financial statements must be provided for the most recent fiscal year and the latest interim period preceding the acquisition of the acquirers that make up the mathematical majority of the test that yields the greatest significance. The requirement under Rule 3-05 to file financial statements of individually insignificant businesses under certain circumstances is applicable only to registration statements and proxies. Form 8-K does not require audited financial statements of insignificant acquirees unless they are “related businesses” and significant on a combined basis (exceeding the 20% level).

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18 Refer to the update on page 14 for proposed rulemaking in this area.
19 Regulation S-X Rule 1-02(w). Significant subsidiary, provides computational details for each of the three tests. See Appendix C for an excerpt of this rule.
20 Refer to the update on page 14 for proposed rulemaking in this area.
21 Table 2 in Appendix B details the financial statement requirements for an initial registration statement.
22 FRM Section 2035.3 provides an example of calculating the mathematical majority.
Financial statements of significant acquirees

In many cases, the businesses acquired or to be acquired may not have been required to prepare and present financial statements, and, even if they have, those statements may not have been audited.

Preparing financial statements and performing the related audit of the financial statements of a business acquired or to be acquired may be a significant undertaking. Rule 3-05 requires the filing of separate pre-acquisition historical financial statements in a registration statement when the acquisition of a significant business has occurred or is probable of occurring. Form 8-K requires such financial statements following consummation of a business combination. See “Predecessor financial information” subsection above for discussion of PBE requirements.

The SEC staff may allow audited statements of assets acquired and liabilities assumed and statements of revenues and direct expenses (i.e., abbreviated financial statements) if it is impracticable to prepare the full financial statements required by Rule 3-05. An explanation of that impracticability must be included in the initial registration statement. For example, in an acquisition of a working interest in an oil and gas property, the acquired property often is not a standalone entity; separate, audited financial statements of the property have not been prepared; and the seller has not maintained the distinct and separate accounts necessary to present the full financial statements of the property. When statements of assets acquired and liabilities assumed and statements of revenues and direct expenses are presented instead of full financial statements, a statement of cash flows generally is not required. However, registrants are required to provide information about the operating, investing and financing cash flows of the business, if available, in the notes to the financial statements or in unaudited supplemental disclosures.

Typically, the use of abbreviated financial information in lieu of full financial statements or carve-out financial statements that comply with SAB Topic 1.B requires pre-clearance from the SEC’s Division of Corporation Finance staff. However, Section 2065.11 of the FRM provides an exception (pre-clearance isn’t required) for Rule 3-05 financial statements when oil and gas properties are acquired if all the following conditions are met:

- The properties acquired are less than substantially all of the seller’s key operating assets.
- The interest acquired is not a segment or division of an entity or contained in a separate legal entity of the seller.
- Separate financial statements of the acquired business (properties) have not previously been prepared and the seller didn’t maintain distinct records to prepare full or carve-out financial statements.
- It’s impracticable to prepare full financial statements that comply with Regulation S-X.

Section 2065.12 of the FRM outlines specific form and content requirements for abbreviated financial statements for acquisitions of oil and gas properties.

Rule 3-05’s reporting requirements, including the computation of the significance tests and related financial statement requirements, are quite complex, and the discussion in this guide only provides a summary of their applicability. Companies should consider consulting with advisors and, in certain instances, seek pre-clearance of certain issues with the SEC’s Division of Corporation Finance staff. For additional information regarding the preclearance process, see “Contacting the staff for advice” on the SEC website at https://www.sec.gov/divisions/corpfin/cfreportingguidance.shtml.

23 FRM 2065, Acquisition of Selected Parts of an Entity May Result in Less than Full Financial Statements

24 For additional information regarding the preclearance process, see “Contacting the staff for advice” on the SEC website at https://www.sec.gov/divisions/corpfin/cfreportingguidance.shtml.

25 FRM 2065.11 and .12, Acquisition of Selected Parts of an Entity may Result in Less than Full Financial Statements – Unique Considerations for Acquisitions of Oil and Gas Properties – General and Additional Guidance.

26 For additional information regarding the preclearance process, see “Contacting the staff for advice” on the SEC website at https://www.sec.gov/divisions/corpfin/cfreportingguidance.shtml.
Update

The SEC has proposed changes to its disclosure requirements for acquisitions and disposals of businesses, and readers should monitor rulemaking in this area.

The proposal aims to improve the financial information registrants provide about businesses they acquire or dispose of, facilitate more timely access to capital, and reduce the complexity and costs of preparing financial information. The proposed changes include the following:

- The SEC proposed changes to the significance tests registrants perform to determine whether to provide financial statements of businesses they acquire and pro forma information for those transactions. Registrants would consider their market capitalization in the investment test and both their revenue and after-tax income in the income test.

- The proposal would replace the requirement that registration statements include financial statements and pro forma financial information for the “mathematical majority” of the acquisitions that are significant in the aggregate.

- The proposal would formalize existing practices around providing abbreviated financial statements of acquired business in certain circumstances.

- The proposal would eliminate any requirement to provide three years of financial statements for an acquired business or a probable acquisition.

See our To the Point publication, SEC proposes changing disclosure requirements for acquisitions and disposals of businesses, for more information.

Accounting for an MLP’s interests in partnerships and limited liability companies

This section addresses an MLP’s interest in other partnerships and similar entities for investment purposes or as a means for holding its substantive business operations. For further discussion related to the accounting for the GP’s investment in the MLP, refer to the section “Accounting and reporting by sponsor entities of MLPs.”

The equity method of accounting is required for interests in limited partnerships and similar entities when the investor does not control the partnership, unless the LP’s interest is “so minor that the limited partner may have virtually no influence over partnership operating and financial policies.” In this case, accounting for the investment in accordance with ASC 321, Investments – Equity Securities, may be appropriate. Because the primary benefit of the MLP business structure is to pass through its income to the LPs without paying federal or state income tax, typically, MLPs hold investments in general partnerships, limited partnerships or limited liability companies to avoid having their earnings in these investments taxed.

Limited partnerships and similar entities

An MLP will first need to determine whether the variable interest model or the voting interest model applies to its investment in the limited partnership.

As discussed in more detail in the subsection “Consolidation considerations” within the section “Accounting and reporting by sponsor entities of MLPs,” the MLP will need to evaluate, among other criteria, whether the limited partners have substantive kick-out or participating rights. If a simple majority (or less) of limited partners (excluding units held by the GP and entities under common control and others acting on the GP’s behalf) cannot exercise substantive kick-out or participating rights, the limited partnership is a variable interest entity (VIE). It may also be a VIE if certain other criteria are met (e.g., it has insufficient equity at risk).

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27 ASC 970-323-25-6, ASC 323-30-599-1.
If an MLP determines its investment is in a limited partnership that is a VIE, it would then need to determine whether it is the primary beneficiary and needs to consolidate the VIE. This would require the MLP to determine whether there is a single decision-maker or shared power. The MLP should consider whether any party (such as the GP of that limited partnership) individually has power and benefits over the limited partnership, considering both direct and indirect interests. If not, the MLP would need to consider whether a related party group (including de facto agents) has power and benefits. Depending on the circumstances, the MLP may need to identify which party is most closely associated with the limited partnership and therefore would be the primary beneficiary of the VIE. While the MLP may not be the primary beneficiary of a VIE, additional disclosures may be required about its involvement with the VIE.

If the limited partnership is not a VIE, the MLP would evaluate it for consolidation under the voting interest model. In this case, the MLP would consolidate only if it holds a majority of the substantive kick-out rights through LP interests.

If the MLP determines it would not consolidate a limited partnership or similar entity, its equity interest in a limited partnership should be accounted for using the equity method of accounting, unless the LP's interest is so minor that it has virtually no influence over the partnership’s operating and financial policies. The SEC staff clarified its view that investments of more than 3% to 5% are considered to be more than minor and, therefore, should be accounted for using the equity method. As a result, investments of as little as 3% in a limited partnership may be subject to the equity method of accounting.

Limited liability companies

A limited liability company (LLC) has characteristics of both a corporation and a partnership but is dissimilar from both in certain aspects. The issue of whether an LLC should be viewed as similar to a corporation or partnership for the consolidation evaluation depends on the governance of the entity, among other factors. An investment in an LLC that maintains a specific ownership account for each investor — similar to a partnership capital account structure — should be viewed as similar to an investment in a limited partnership for purposes of determining whether a noncontrolling investment in the LLC should be accounted for in accordance with the guidance in ASC 321 or the equity method.

If an LLC is determined to be similar to a partnership, the accounting would be as previously discussed above.

An investment in an LLC that is viewed as similar to a corporation would be treated as such for purposes of determining the appropriate accounting (e.g., consolidation, equity method) for an interest in the entity. The equity method of accounting is required for investments in the common stock or in-substance common stock of a corporation when the investor does not control an investee but has the ability to exercise significant influence over the investee's operating and financial policies. "Significant influence" is presumed to exist for investments of 20% or more of the voting stock of a corporation.

This equity method guidance in ASC 323-30, Investments — Equity Method and Joint Ventures — Partnerships, Joint Ventures, and Limited Liability Entities, does not apply to investments in an LLC that are equity in legal form but are required to be accounted for as debt securities.

Other resources

Financial reporting developments, Consolidation: Determination of a controlling financial interest and accounting for changes in ownership interests

Financial reporting developments, Equity method investments and joint ventures
Convertible equity securities

MLPs may issue other classes of partnership units (e.g., subordinated, Class B, Class C) that are subordinated and convertible into common units. If the convertible unit holders do not elect to convert their units into common units, then the common unit holders have the right to either (1) force conversion or (2) receive additional distributions (e.g., 115% of what the common distribution would have been). These subordinated partnership units may be issued at a discount to the price of the common units.

In other instances, MLPs will issue subordinated units that will automatically convert to common units when certain conditions are met (e.g., the MLP declares distributions above the minimum quarterly distribution (MQD) for eight consecutive quarters).

Some MLPs issue classes of partnership units that participate in distributions and the MQD similar to the common units, but they are only paid in additional shares, rather than cash.

When there are embedded conversion features in the securities, the MLP will need to evaluate whether those provisions require bifurcation under ASC 815, Derivatives and Hedging, as a derivative or other separate accounting under ASC 470-20-25, Debt – Debt with Conversion and Other Options – Recognition. Also, the conversion feature should be considered when calculating EPU. See “Earnings per unit” subsection below for further discussion.

Puttable or redeemable equity securities

Typically, MLPs do not issue limited partnership interests that are redeemable (e.g., at the option of the holder (puttable) or that are mandatorily redeemable). However, if these types of instruments are issued by the MLP, the MLP should evaluate the guidance in ASC 480-10, Distinguishing Liabilities from Equity – Overall, including the guidance from the SEC staff on classification and measurement of redeemable securities in ASC 480-10-S99-3A, to determine the appropriate classification and measurement of these redeemable limited partnership interests. Further, the MLP should evaluate whether the embedded redemption features should be bifurcated pursuant to the guidance in ASC 815.

Presentation of partnership equity accounts

SAB Topic 4.F, Limited Partnerships (SAB Topic 4.F), addresses how the financial statements of limited partnerships (including MLPs) should be presented so that the two ownership classes (i.e., the LP(s) and the GP) can readily determine their relative participation rights in both the net assets of the partnership and in the results of its operations. For MLPs, there may be multiple classes of LP interests, including common and subordinated LP interests.

The equity section of the limited partnership balance sheet should distinguish between amounts ascribed to each ownership class. The equity attributed to the GP should be stated separately from the equity of the LPs, and changes in the number of equity units authorized and outstanding should be shown for each ownership class. In some cases, partnership agreements may not provide a limit for the number of units authorized. If that’s the case, the MLP should consider disclosing that fact. A statement of changes in partnership equity for each ownership class should be furnished for each period for which an income statement is included.

The income statement of limited partnerships should be presented in a manner that clearly shows the aggregate amount of net income (loss) allocated to the GP and the aggregate amount allocated to the LPs (or each class of LPs). The income statement also should state the results of operations on a per unit basis for interests held by the public (i.e., per unit amounts are often not presented for the GP interest or subordinated interests held by the consolidating sponsor entity).

The FASB has proposed changes to ASC 470-20 and 815-40 that may affect the accounting in this area. Readers should monitor developments in this area.
SAB Topic 4.F, Limited Partnership

| Facts | There exist a number of publicly held partnerships having one or more corporate or individual general partners and a relatively larger number of limited partners. There are no specific requirements or guidelines relating to the presentation of the partnership equity accounts in the financial statements. In addition, there are many approaches to the parallel problem of relating the results of operations to the two classes of partnership equity interests. |
| Question | How should the financial statements of limited partnerships be presented so that the two ownership classes can readily determine their relative participations in both the net assets of the partnership and in the results of its operations? |
| Interpretive Responsive | The equity section of a partnership balance sheet should distinguish between amounts ascribed to each ownership class. The equity attributed to the general partners should be stated separately from the equity of the limited partners, and changes in the number of equity units authorized and outstanding should be shown for each ownership class. A statement of changes in partnership equity for each ownership class should be furnished for each period for which an income statement is included. The income statements of partnerships should be presented in a manner which clearly shows the aggregate amount of net income (loss) allocated to the general partners and the aggregate amount allocated to the limited partners. The statement of income should also state the results of operations on a per unit basis. |
Allocating earnings between the GP and the LP

MLPs typically use the profit-sharing arrangement detailed in a partnership agreement (when substantive) to allocate earnings to the capital accounts between the GP and LPs (and in some cases subordinated units). The partnership agreement usually provides that net income and losses are allocated to the GP and the LPs based on their ownership interests. Many agreements stipulate that the LPs’ accounts cannot be negative. Priority allocations to the IDR holders under the MLP’s partnership agreement should also be considered in the allocation of earnings to the capital accounts.

When distributions are made to the IDR holders, as required by the partnership agreement, earnings equal to the amount of the distributions made or that will be made are allocated to the interest holders prior to allocations based on the ownership percentages to the capital accounts. Because the IDR holders (often the GP) participate in the distributions to varying degrees, this allocation can lead to significant deviations from ownership percentages when allocating earnings.

For example, assume a GP owns 2% of the MLP. If net income is $110 million and the IDR holders (in this case, the GP) received $10 million in incentive distributions, net income of $12 million and $98 million would be allocated to the GP and LPs, respectively. The GP’s net income is calculated by deducting $10 million from $110 million, multiplying the sum by 2% and adding $10 million. The LP’s net income is calculated by deducting $10 million from $110 million and multiplying the sum by 98%.

Earnings per unit

Publicly traded MLPs typically issue multiple classes of securities that participate in partnership distributions according to a formula specified in the partnership agreement. A typical MLP consists of publicly traded common units (and in some cases, subordinated units) held by LPs, a GP interest and IDRs. IDRs may be a separate non-voting LP interest that the GP initially holds, but may be transferable apart from its GP interest. IDRs may also be embedded in the GP interest such that they cannot be transferred separately from the GP’s overall interest in the MLP.

In many cases, the partnership agreement obligates the GP to distribute 100% of the partnership’s available cash (as that term is defined in the partnership agreement) to the LPs, GP and, when certain thresholds are met, the IDR holder(s), based on a distribution waterfall schedule in the partnership agreement. Partnership agreements generally state that the holder(s) of IDRs are not entitled to distributions other than those provided in the distribution waterfall of 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 after taking into account any priority income allocations (or distributions) to the unit holders, including IDRs.

Because the GP and LPs both participate in the distribution of earnings, MLPs are required to calculate EPU using the two-class method. ASC 260, Earnings Per Share, requires the presentation of basic and diluted EPU for classes of equity that are equivalent to common stock. Presentation of EPU for other securities is not precluded. While common LP units often may be considered equivalent to common stock, MLPs will need to evaluate all classes of equity to determine the required EPU presentation.

A complexity may arise in a period when new LP units are issued. Because those units participate in cash distributions, they may participate in earnings allocations under the two-class method for the entire reporting period even though they were not outstanding for the entire period. The MLP must then apply a rational approach to allocating the undistributed earnings to the various interests, including the LP units that were only outstanding for a partial period.

IDRs and participating securities

The guidance on MLPs in ASC 260 applies to MLPs that both (1) are required to make incentive distributions when certain contractually specified thresholds are met and (2) account for the incentive distributions as equity distributions. ASC 260 does not apply to incentive distributions accounted for as compensation cost. IDRs that are a separate class of LP interest (i.e., the IDRs are transferable and not embedded in the GP interest) are participating securities. If the IDRs are not transferable separate from the GP interest, they are not participating securities. However, the GP interest with its respective embedded IDRs are a participating security.
Allocation of earnings and losses to determine EPU

IDRs are separately transferable

If IDRs are separately transferable, earnings or losses for a reporting period should be allocated to the GP, LPs and the IDR holder(s) (collectively the participating security holders) when calculating EPU under the two-class method. Under this method, net income (or loss) for a reporting period must be reduced (or increased) by the amount of available cash that has been or will be distributed to the participating security holders for that reporting period. Because partnership agreements generally obligate the GP to distribute available cash for each reporting period within a certain number of days after the end of the reporting period (e.g., 60 days), the GP will need to determine available cash to be distributed to the participating security holders prior to issuing financial statements for each reporting period. The distributions of available cash to the participating security holders are generally based on a waterfall schedule (or some other distribution methodology) that is stipulated in the partnership agreement.

After adjusting net income for the reporting period by the amounts distributed or to be distributed to the participating security holders, any undistributed earnings should be allocated to the participating security holders, including the IDR holder(s), pursuant to the terms of the partnership agreement. Thus, if the partnership arrangement contractually limits the amount of distributions to the IDR holder(s), undistributed earnings should not be allocated to them in excess of the specified amount.

To determine whether distributions to the IDR holder(s) are contractually limited, the MLP will need to evaluate whether distributions for a reporting period would be limited to available cash even if all earnings for the period were distributed (for example, in the event of a liquidating dividend). Typically, partnership agreements specify that distributions to the IDR holder(s) for a reporting period are contractually limited to the holder’s share of available cash distributed for the current reporting period. When distributions are contractually limited, all undistributed earnings or losses would be allocated to the GP and LPs, and no undistributed earnings or losses would be allocated to the IDR holder(s). However, if the partnership agreement is silent or does not explicitly limit distributions to the IDR holder(s), the MLP should allocate undistributed earnings or losses to the participating security holders, including the IDR holder(s), using the distribution waterfall schedule or another distribution method specified in the partnership agreement.

When distributions to the participating security holders exceed earnings for the reporting period, net income (or loss) would be reduced (or increased) by actual distributions. The resulting net undistributed loss normally should be allocated to the GP and LPs based on the method of allocating losses specified in the partnership agreement. Losses should be allocated to the IDR holder(s) only if they are contractually obligated to participate in losses.

IDRs are not separately transferable

IDRs that are embedded and not separately transferable from the GP interest are not separate participating securities. However, MLPs are still required to compute EPU under the two-class method because the GP and LP interests are separate classes of equity. When the IDRs are embedded in the GP interest, MLPs will follow the same guidance used when the IDRs are a separate LP interest, except that all distributions and allocations of undistributed earnings (or losses) related to the IDRs are aggregated with the distributions and allocations of earnings (or losses) to the GP interest. As a result, the effect on the calculated EPU for the LP interests would be the same regardless of whether the IDRs are a separate LP interest or are embedded in the GP interest.

However, the calculated EPU for the GP interest, in many cases, will be higher than if the IDRs were considered separate participating securities.

Determination of available cash

The requirement to determine the contractual obligation to the holder(s) of IDRs at the end of a reporting period will require MLPs to determine available cash at the end of a reporting period before the financial statements for that period are issued. This requirement may cause some MLPs to accelerate the timing of the determination of available cash. While MLPs are required to determine available cash prior to issuing their financial statements for purposes of calculating EPU, it does not require MLPs to record a distribution payable prior to distributions being declared. For example, if an MLP determines available cash in April 20X0 for their first quarter of the calendar-year 20X0 reporting period, the MLP would not record a distribution payable until April 20X0, when the distribution is actually declared, even though the distributions will be used to compute EPU for the first quarter reporting period.
Year-to-date calculation

The computation of EPU for a year-to-date or annual period under the two-class method should be made without regard to the quarterly computations. That is, earnings for the annual period and for each year-to-date period should be allocated to the unit classes independent of any previously computed quarterly earnings allocations.

Allocation of earnings and losses in the period prior to a dropdown

When an existing MLP receives net assets in a dropdown transaction that is accounted for as a transaction between entities under common control in accordance with ASC 805-50, for purposes of calculating historical EPU under the two-class method, the earnings (or losses) of transferred net assets before the date of a dropdown transaction should be allocated entirely to the general partner interest. In that circumstance, the previously reported EPU of the LP would not change as a result of the dropdown transaction. MLPs are also required to make qualitative disclosures about how the rights to the earnings (or losses) differ before and after the dropdown transaction for purposes of computing EPU under the two-class method.

Dividend policy disclosures

The SEC staff believes that certain disclosures regarding the intention to pay future dividends are necessary in initial registration statements. In the case of MLP offerings, the registration statement typically states that the MLP will distribute all available cash to unit holders. However, the distributions generally are not guaranteed since a majority of common unit holders can modify the partnership agreement. Further, the current owners (prior to the IPO) likely will still have significant control of the entity after the IPO and the ability to unilaterally modify the partnership agreement.

The SEC staff believes the following disclosures are necessary in registration statements (outside of the audited financial statements, given the forward-looking nature of the disclosures) for IPOs where the registrant indicates its intention to pay a significant amount of dividends:

- A detailed dividend policy description that provides a discussion of material risks and limitations, including (1) the fact that the distribution rate could be changed or eliminated at any time, (2) the effects of debt covenants and state laws on the proposed dividend policy, (3) the risks to growth of paying out all excess cash as dividends and (4) the effect on future debt repayment
- Forward-looking information about cash available for distribution
- Disclosures supporting whether the registrant would have been able to achieve its distribution policy historically if the new policy had been in place at that time

Other resources

Financial reporting developments, Earnings per share
The forward-looking information about cash available for distribution should include a reconciliation of expected cash earnings to cash available for distribution. This reconciliation should start with a measure that the MLP considers to be highly correlated to cash. In some situations, it may be appropriate for an MLP to start with a non-GAAP measure such as earnings before interest, taxes, depreciation and amortization (EBITDA), assuming the registrant is able to assert that this measure is highly correlated to cash. Adjusted EBITDA also may be appropriate if calculated consistently with the measure contained in the MLP’s debt covenants and the MLP is able to assert that the measure is highly correlated to cash.

The historical information supporting whether the MLP would have been able to achieve the proposed distribution policy should include a reconciliation of GAAP cash flows from operating activities to cash available for distributions. This reconciliation also should include reconciling items for things such as the additional costs associated with being a public company and adjustments for changes in interest expense expected as a result of the IPO or recapitalization occurring concurrently with the IPO. MLPs should include detailed disclosures about the assumptions used in deriving these amounts. In addition, if the MLP would not have been able to pay the dividends at the intended level based on historical amounts, it should clearly disclose why it believes it will be able to pay the dividends going forward.

MLPs also should include detailed disclosures about the assumptions used in arriving at the forward-looking information, including the risks and expected outcomes if the targets are not achieved. This disclosure may consist of a bullet point list of assumptions and a discussion about any changes from historical amounts. The MLP should discuss any effects on compliance with debt covenants based on the forward-looking operating results and expected cash flow information. MD&A disclosure also should include the intended dividend policy for the next year and how the MLP expects to fund the distribution.

## Accounting and reporting by sponsor entities of MLPs

This section discusses various considerations that may be applicable to the preparation of financial statements for the sponsor entity of an MLP.

### Consolidation considerations

The purpose of consolidated financial statements is to present the results of operations and the financial position of a parent and its subsidiaries as if the group were a single company. Thus, the sponsor entity must evaluate whether to consolidate the MLP.

When applying consolidation accounting, the sponsor entity must first determine whether the MLP is a VIE or a voting interest entity. Accordingly, a sponsor entity must determine whether it has a variable interest in the MLP, and whether the MLP is a VIE under ASC 810. If the MLP is a VIE, it is consolidated by the primary beneficiary. Only if the MLP is not a VIE should consolidation be based on an evaluation of voting interests.

This determination will vary depending on the facts and circumstances of each arrangement. This publication summarizes key considerations in making the evaluation.

### Other resources

Financial reporting developments, *Consolidation: Determination of a controlling financial interest and accounting for changes in ownership interests*.

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34 This assumes that no scope exclusions from the consolidation guidance or the VIE subtopic are applicable.
Variable interest entity considerations

An MLP is a VIE if:

- It does not have enough equity to finance its activities without additional subordinated financial support.
- The equity holders as a group lack the characteristics of a controlling financial interest.

Or

- The entity is structured with non-substantive voting rights (i.e., an anti-abuse clause).

When determining whether equity is sufficient for the MLP to finance its operations, only equity investments at risk (i.e., equity investments in the entity that participate significantly in both profits and losses) should be considered. The sufficiency of equity at risk can be demonstrated (1) by demonstrating that the MLP has the ability to finance its activities without additional subordinated financial support, (2) by having at least as much equity as a similar entity that finances its operations with no additional subordinated financial support, or (3) by comparing the MLP’s at-risk equity investment with its calculated expected losses. If the equity investment at risk is not sufficient to permit the MLP to carry on its activities without additional subordinated financial support, the MLP is a VIE.

An MLP also is a VIE if the equity holders, as a group, lack the characteristics of a controlling financial interest, which are:

- The power, through voting rights or similar rights, to direct the activities of an entity that most significantly impact the entity’s economic performance
- The obligation to absorb an entity’s expected losses
- The right to receive an entity’s expected residual returns

Because an MLP is a limited partnership, the analysis of the power criterion will focus on whether the limited partners hold substantive kick-out rights or participating rights. Further, the sponsor entity will need to evaluate if a single limited partner or a simple majority of the limited partners (excluding interests held by the GP and its related parties under common control, or others acting on its behalf) could exercise those rights and remove the GP or block the decisions that most significantly affect the MLP’s economic performance. Most MLP structures do not provide this level of rights to limited partners, either because (1) the GP owns such a substantial number of the LP units (directly or indirectly) to prevent those rights from being exercised or (2) the rights can only be exercised by a supermajority of interests held by entities other than the GP. Therefore, most MLPs likely will be VIEs under the guidance in ASC 810.

Additionally, an MLP is a VIE if the equity owners, as a group, do not have the obligation to absorb the expected losses and the right to receive the expected residual returns of the MLP. Therefore, holders of the equity investment at risk, as a group, cannot be shielded from the risk of loss by the MLP itself, or by others that are involved with the MLP. Their returns also cannot be capped by the MLP’s governing documents or arrangements with other variable interest holders of the MLP.

The variable interest model also contains an anti-abuse test to prevent a reporting entity from avoiding consolidation of an MLP by organizing the MLP with non-substantive voting interests. Under this test, an MLP is a VIE if (1) the voting rights of some investors are not proportional to their obligations to absorb the MLP’s expected losses, their rights to receive the MLP’s expected residual returns or both and (2) substantially all of the MLP’s activities either involve or are conducted on behalf of an investor that has disproportionately few voting rights, including its related parties, and certain de facto agents.
Primary beneficiary determination

If the sponsor entity determines that the MLP is a VIE, it must evaluate whether it is the VIE’s primary beneficiary. When identifying the primary beneficiary absent substantive kick-out or participating rights held by the limited partners, the sponsor entity (i.e., the GP) typically has power as a single decision maker and has benefits through its variable interests in the MLP (e.g., its GP interest, LP units, IDRs, fees). Therefore, the GP likely will be the primary beneficiary of the MLP and consolidate it.

However, each sponsor entity will need to perform the full analysis to consider its own facts and circumstances.

Voting interest entity considerations

If the MLP is not a VIE, it is evaluated under the voting interest model. If it is not a VIE, then that means, among other things, that a simple majority (or less) of the LPs can exercise either substantive kick-out or participating rights (or both) that allow them to direct the MLP’s activities that most significantly impact the MLP’s economic performance. As a result, under the voting interest model, a GP does not have control of a limited partnership; that is, a GP will not consolidate an MLP that is not a VIE. Instead, if the MLP is not a VIE, no entity will consolidate it unless there is a single limited partner that holds a majority of the substantive kick-out or participating rights.

Noncontrolling interest presentation

If the sponsor entity controls the MLP, the sponsor entity will present as a noncontrolling interest any equity interests in the MLP (or any other non-wholly-owned subsidiary) that are not attributable to the sponsor entity in its consolidated financial statements.

A noncontrolling interest is classified as equity and presented separately from the equity of the sponsor entity so users of the consolidated financial statements can distinguish the parent’s equity from the equity attributable to other owners.

Attribution of net and comprehensive income

While ASC 810 requires net income or loss and comprehensive income or loss to be attributed to the controlling interest and noncontrolling interest, it does not prescribe a method for making that attribution (ASC 810-10-45-18 through 45-21).

We believe that net income or loss and comprehensive income or loss of a partially owned consolidated MLP should be attributed to controlling interest and noncontrolling interest based on the terms of a substantive profit-sharing agreement. Formulas used to allocate taxable earnings for regular cash distributions may be different than those used to allocate liquidating distributions. In these situations, the allocation used for financial reporting purposes should representationally reflect the allocations of earnings to which the parties agreed. ASC 970-323-35-17 provides guidance on the allocation of income or loss for real estate investments accounted for under the equity method. We believe the same concepts apply when allocating income or loss to controlling and noncontrolling interests.

Determining whether a profit-sharing arrangement is substantive is a matter of individual facts and circumstances, including whether IDRs exist, requiring the use of professional judgment.

If a substantive profit-sharing agreement does not exist, we generally believe that the relative ownership interests in the subsidiary (e.g., the MLP) should be used. In this case, the attribution of the noncontrolling interest may be as simple as multiplying the net income or loss and comprehensive income or loss of the partially owned subsidiary by the relative ownership interests in the subsidiary.

We have observed the SEC staff ask public companies to enhance their disclosures by stating how such allocations among controlling and noncontrolling interests are made. Therefore, we believe it is appropriate to disclose the terms and effects of any material substantive profit-sharing arrangement.
**Attribution of losses**

ASC 810 requires losses to be attributed to the noncontrolling interest, even when the noncontrolling interest’s basis in the partially owned subsidiary has been reduced to zero (ASC 810-10-45-21). Under ASC 810, the noncontrolling interest is considered equity of the consolidated group and participates in the risks and rewards of an investment in the subsidiary. Therefore, noncontrolling interests are attributed their share of losses just like the parent, even if the noncontrolling interest balance becomes a deficit. When the noncontrolling interest balance becomes a deficit, any excess loss attributed to the noncontrolling interest is reported in the consolidated financial statements as a deficit balance in the noncontrolling interest line in the equity section.

However, entities should carefully evaluate their facts and circumstances to determine the appropriate attribution of income and losses. For example, entities should carefully consider whether contractual arrangements may provide for disproportionate sharing of losses among the controlling and noncontrolling interest holder.

The provisions of MLP partnership agreements typically stipulate that net losses not be allocated to the LPs if the allocation would cause the LPs to have a deficit in their capital account. The partnership agreement often requires the net losses to be allocated to the GP. In these situations, the parent company would not reduce the noncontrolling interest of the MLP below zero, and the recovery of losses would be recognized based on the partnership agreement. Therefore, if substantive contractual arrangements (such as many that are present in MLP partnership agreements) limit the allocation of losses to the amount of the noncontrolling interest’s investment in the MLP, losses are allocated to the noncontrolling interest for financial reporting purposes when there is a positive (credit) balance in the noncontrolling interest account on the parent’s books. At the point the balance reaches zero, if the provisions in the agreement are deemed to be substantive, any additional losses are allocated only to the GP (i.e., the controlling interest on the parent’s books).

**Cash flow statement presentation**

Since MLPs typically distribute most, if not all, of their earnings to the partners, the question arises as to how the parent company should present the distributions made to the noncontrolling interest holders in its statement of cash flows. ASC 230, *Statement of Cash Flows*, does not provide specific guidance on how to classify distributions to noncontrolling interest holders. However, we believe that the classification of payments to the noncontrolling interest holders should be consistent with the rationale for the classification of noncontrolling interest as equity in the statement of financial position.

The basis for this presentation is the economic entity concept of consolidated financial statements. Under the economic entity concept, all residual economic interest holders in an entity have an equity interest in the consolidated entity, even if the residual interest is relative to only a portion of the entity (i.e., a residual interest in a subsidiary). Therefore, a noncontrolling interest is required to be displayed in the consolidated statement of financial position as a separate component of equity. Consistent with this view, a parent company should reflect distributions made to the noncontrolling interest holders as financing activities in its statement of cash flows.

**Other resources**

Financial reporting developments, *Statement of cash flows*
Issuance of equity by an MLP that does not result in loss of control by the sponsor entity

If a sponsor entity controls an MLP that sells LP interests that decrease the sponsor entity’s ownership of the MLP but the sale does not result in the sponsor entity losing control of the MLP, the sponsor entity must determine whether the transaction is in the scope of ASC 932-360; ASC 606, Revenue from contracts with customers; ASC 610-20, Other Income — Gains and Losses from the Derecognition of Nonfinancial Assets; or ASC 810, as follows:

- The guidance in ASC 932-360 should be followed if the transaction is a conveyance of oil and gas mineral rights, regardless of whether the MLP meets the definition of a business.
- The guidance in ASC 606 should be followed if the transaction is a sale to a customer, regardless of whether the MLP meets the definition of a business.
- The guidance in ASC 610-20 should be followed if the transaction is a sale or transfer to noncustomers of nonfinancial assets or in substance nonfinancial assets that do not meet the definition of a business.
- The guidance in ASC 810-10 should be followed if the transaction results in a decrease in ownership of the MLP (1) that is a business in a transaction with noncustomers or (2) for which the substance of the transaction is not addressed by other US GAAP.

If the transaction is in the scope of ASC 810, the carrying amount of the noncontrolling interest should be increased to reflect the change in the noncontrolling interest’s ownership in the subsidiary’s net assets (i.e., the ending amount attributed to the noncontrolling interests should reflect its ownership of the MLP’s net assets inclusive of any consideration received by the subsidiary).

Any difference between the consideration received (whether by the parent or the MLP subsidiary) and the adjustment made to the carrying amount of the noncontrolling interest should be recognized directly in equity attributable to the controlling interest (e.g., as an adjustment to additional paid-in capital in the consolidated financial statements). These transactions can lead to book-tax basis differences that the sponsor entity also may need to consider.

Subordinated LP units

The guidance in ASC 810 for accounting for a change in a parent’s ownership interest when control is retained may not apply when an MLP issues limited partnership units that have a preference in distributions or liquidation rights (referred to as the common LP units). It is common for an MLP partnership agreement to provide that, during a subordination period, the common LP units have the right to receive distributions of available cash each quarter based on a minimum quarterly distribution, plus any arrearages, before any distributions of available cash may be made on the subordinated LP units. Furthermore, no arrearages will be paid on the subordinated units.

The practical effect of the subordinated LP units is to increase the likelihood that during the subordination period there will be available cash to distribute to the common LP units. During the period that subordinated LP units are outstanding, common LP units do not possess the characteristics of a residual equity interest given the common LP units’ preference over the subordinated LP units.

We believe that if the class of security issued by the MLP subsidiary has a preference in distribution or liquidation rights over any other class of equity security, then it often is analogous to preferred stock and would be reflected as a noncontrolling interest at the amount of cash proceeds received with no adjustment to the parent’s equity account.

Expiration of the subordination period

MLP partnership agreements include provisions for the subordination period to expire after a specific period of time if the minimum quarterly distributions have been made to the holders of the common LP units. Upon the expiration of the subordination period, all subordinated LP units have the same distribution and liquidation rights as the other common LP units.

Although the common LP units previously issued by the MLP to the holders of the noncontrolling interest no longer have a preference in distributions due to the expiration of the subordination period, we believe this loss of preference has no immediate accounting consequences. The accounting for changes in noncontrolling interests only applies to changes in a sponsor entity’s ownership interest in an MLP, which includes circumstances in which “(a) the parent purchases additional ownership interests in its subsidiary, (b) the parent sells some of its ownership interests in its subsidiary, (c) the subsidiary reacquires some of its ownership interests, or (d) the subsidiary issues additional ownership interests” (ASC 810-10-45-22).

Other resources

Financial reporting developments, Consolidation: Determination of a controlling financial interest and accounting for changes in ownership interests, Section 18
We believe the expiration of the subordination period is not a change in the parent’s ownership interest in a subsidiary because the expiration does not result in a change in ownership interest in the MLP. As such, there is no adjustment to be recognized to the equity accounts of the sponsor entity or noncontrolling interest as a result of the expiration of the preferences.

Loss of control and deconsolidation considerations

A sponsor entity may lose control over, and thus be required to deconsolidate, an MLP.

The sponsor entity must determine whether a transaction that results in a loss of control of an MLP is in the scope of ASC 932-360, ASC 606, ASC 610-20, or ASC 810, as follows:

• The guidance in ASC 932-360 should be followed if the transaction is a conveyance of oil and gas mineral rights, regardless of whether the MLP meets the definition of a business.
• The guidance in ASC 606 should be followed if the transaction is a sale to a customer, regardless of whether the MLP meets the definition of a business.
• The guidance in ASC 610-20 should be followed if the transaction is a sale or transfer to noncustomers of nonfinancial assets or in substance nonfinancial assets that do not meet the definition of a business.
• The guidance in ASC 810-10 should be followed if (1) the transaction is a sale or transfer of a business to noncustomers or (2) the substance of the transaction is not addressed by other US GAAP.

Goodwill impairment considerations

When testing goodwill for impairment, the MLP should test goodwill based on its reporting unit determination following the guidance in ASC 350-20, Intangibles – Goodwill and Other – Goodwill. In certain cases, the reporting units identified at the MLP level may be the same as the reporting units of the consolidated parent company. Differences in the composition of the businesses and how the businesses are managed at the parent and MLP, including differences in segment reporting conclusions, may contribute to a different reporting unit determination by the parent and MLP, respectively.

Accordingly, the MLP’s reporting units used in its goodwill impairment analysis may differ from the consolidated parent company. If the MLP is required to recognize goodwill impairment in its standalone financial statements, that impairment is not recognized in the parent company’s financial statements (i.e., the impairment is not “pushed up” to the higher level of consolidation), which could lead to recurring consolidating adjustments. However, the parent company should consider whether a goodwill impairment loss recognized at the MLP indicates that the goodwill of the reporting unit or units in which the MLP resides should be tested.

Similarly, a goodwill impairment loss recognized by the parent is not “pushed down” to the MLP. Rather, the MLP would apply ASC 350-20 in its own standalone financial statements.

Other resources

Financial reporting developments, Consolidation: Determination of a controlling financial interest and accounting for changes in ownership interests

Financial reporting developments, Gains and losses from the derecognition of nonfinancial assets (ASC 610-20)
Other matters

Income tax-related matters

The following are some income-tax related matters that may affect an MLP or its sponsor entity (ASC 740, Income Taxes).

Changes in the tax status of an enterprise

Some forms of businesses, such as partnerships, certain LLCs and S corporations, generally are not subject to income taxes. However, as a result of changes in tax law, or changes in elections, an entity may change from nontaxable to taxable status or vice versa.

ASC 740-10-45-19 requires that the deferred tax effects of a change in tax status be included in income from continuing operations. When an entity changes its tax status and becomes subject to income taxes, deferred tax assets and liabilities should be recognized for existing temporary differences (ASC 740-10-25-32). Likewise, when a taxable enterprise ceases to be taxable, deferred tax assets and liabilities should be eliminated (ASC 740-10-40-6).

An election for a voluntary change in tax status is recognized at the time the change is effective in accordance with the applicable tax laws, which is the date the approval for the change is granted by the taxing authorities if required, or on the filing date, if approval is not necessary (ASC 740-10-25-33). An adjustment should not be made merely because a change in the status is planned. For example, a taxable corporation should not eliminate deferred taxes because it planned to change to S corporation status. A change in tax status that results from a change in tax law is recognized on the enactment date, similar to other tax law changes.

Noteworthy is that an MLP is treated as a partnership for US federal income tax purposes so long as certain criteria are met. If the MLP no longer qualifies for treatment as a partnership for US federal income tax purposes, the income tax effects should be recognized in the period the tax status changed.

Subsequent event

If an election to change an entity’s tax status is approved by the tax authority (or filed, if approval is not necessary) after the end of a year but before the financial statements for the year are issued, the change in tax status would be reflected in the period in which the change is approved by the tax authority (or filed, if approval is not necessary), as noted above.

In these circumstances, disclosure of the pending change and the effects of the change should be included in the notes to the financial statements as a subsequent event. Pro forma disclosure requirements should also be considered.

If a change in the tax law that causes a change in an entity’s tax status is enacted after the balance sheet date but before the issuance of the financial statements, the effect of that change is reflected in the period in which the tax law is enacted under the provisions of ASC 740-10-45-15.

Other income taxes

Although the federal government may recognize the MLP as a partnership (i.e., pass-through entity), certain jurisdictions may impose taxes that are in-substance income taxes. For example, Texas imposes a margin tax on entities, including MLPs, which is based substantially on income, and as such we believe is subject to the provisions of ASC 740. MLPs should evaluate taxes imposed by all jurisdictions in which they operate to determine whether such taxes are income taxes that are in the scope of ASC 740.

Income tax-related compliance

Although the MLP may not be subject to US federal income tax, it is still subject to other federal tax reporting requirements and regulations. For example:

- MLPs must evaluate their income to determine whether their sources of otherwise taxable revenue continue to qualify to maintain their pass-through entity status.
- MLPs also must provide Schedule K-1 information for each GP and LP as part of tax reporting, all with separate investment bases. Providing this information can require substantially more recordkeeping than providing a Form 1099 for dividends that stockholders receive from a taxable corporation. The Schedule K-1 requires record keeping for transactions between unit holders that are outside the MLP’s control.
Sponsor entity income tax effects

Although the earnings of the MLP may not be subject to income tax at the MLP level, the parent entity often will be subject to income tax reporting. This can lead to financial reporting and disclosure complexities for income taxes, including the rate reconciliation.

As discussed in previous sections, upon formation of the MLP, the sponsor may or may not retain control of the MLP. In situations, when control is lost, the sponsor may continue to retain a noncontrolling interest in the MLP. In these situations, when the MLP is established, the sponsor derecognizes all of the assets and liabilities contributed, including any deferred taxes on inside basis differences. If the sponsor retains an equity interest in the MLP, an adjustment to deferred taxes may be necessary to appropriately reflect the tax effects of any outside basis differences in the retained equity interest. For example, if the sponsor previously did not provide for deferred taxes on outside basis differences because the subsidiary met one of the exceptions to recognizing deferred tax liabilities within ASC 740, deferred taxes on any outside basis difference should be recognized. Generally, this is at the time the sponsor decides to no longer retain control (but no later than when control is lost).

SEC filing status and internal control over financial reporting following a spin-off

The SEC staff agreed that, after an entity spins off from a registrant, it should make its own assessment of its accelerated filer status based on the criteria set forth in Exchange Act Rule 12b-2. However, Release 33-8760, Final Rule: Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers and Newly Public Companies, indicates that, because of the interrelationship between Form S-3 eligibility and accelerated filer status, the SEC staff believes that, if a newly-formed public company seeks to use and is deemed eligible to use Form S-3 on the basis of another entity's reporting history (e.g., its former parent or a predecessor) consistent with Staff Legal Bulletin 4, that company also would be an accelerated filer subject to full reporting requirements on internal control over financial reporting (ICFR) required by Section 404 of the Sarbanes-Oxley Act of 2002 (Section 404) in its first annual report on Form 10-K (i.e., it would not be eligible for the ICFR reporting relief in its first Form 10-K that is otherwise available to a newly public company).

If, however, the newly public company does not seek to use another entity's reporting history for purposes of meeting the eligibility requirements of Form S-3, the newly public company should evaluate its status as an accelerated filer (and a newly public company) based on the criteria set forth in Exchange Act Rule 12b-2. In those circumstances, its first annual report would not be subject to accelerated filing deadlines (and would not be required to comply with Section 404 reporting).

In addition to the relief for newly public companies, EGCs may defer the auditor attestation requirement of Section 404. That is, even if an EGC is an accelerated filer at the end of the second fiscal year ending after it becomes a public company, it will not have to obtain an audit of its ICFR for that year’s Form 10-K as long as it continues to qualify as an EGC. However, an EGC would still have to provide a report by management assessing the effectiveness of the entity’s ICFR in that Form 10-K.

Other resources

Financial reporting developments, Income taxes

35 SEC Regulations Committee Minutes 15 June 2004, Current Practice Issue C.
Appendix A

<table>
<thead>
<tr>
<th>Excerpt from SAB Topic 5.Z.7, Accounting for the Spin-off of a Subsidiary</th>
</tr>
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<tbody>
<tr>
<td><strong>Facts</strong></td>
</tr>
<tr>
<td><strong>Question</strong></td>
</tr>
<tr>
<td><strong>Interpretive response</strong></td>
</tr>
</tbody>
</table>
### Excerpt from SAB Topic 1.B, Allocation of Expenses and Related Disclosure in Financial Statements of Subsidiaries, Divisions or Lesser Business Components of Another Entity

<table>
<thead>
<tr>
<th><strong>Facts</strong></th>
<th>A company (the registrant) operates as a subsidiary of another company (parent). Certain expenses incurred by the parent on behalf of the subsidiary have not been charged to the subsidiary in the past. The subsidiary files a registration statement under the Securities Act of 1933 in connection with an initial public offering.</th>
</tr>
</thead>
</table>
| **Question** | Costs reflected in historical financial statements

Question 1: Should the subsidiary’s historical income statements reflect all of the expenses that the parent incurred on its behalf? |
| **Interpretive Response** | In general, the staff believes that the historical income statements of a registrant should reflect all of its costs of doing business. Therefore, in specific situations, the staff has required the subsidiary to revise its financial statements to include certain expenses incurred by the parent on its behalf. Examples of such expenses may include, but are not necessarily limited to, the following (income taxes and interest are discussed separately below):

1. Officer and employee salaries
2. Rent or depreciation
3. Advertising
4. Accounting and legal services, and
5. Other selling, general and administrative expenses.

When the subsidiary’s financial statements have been previously reported on by independent accountants and have been used other than for internal purposes, the staff has accepted a presentation that shows income before tax as previously reported, followed by adjustments for expenses not previously allocated, income taxes, and adjusted net income. |
| **Question** | Question 2: How should the amount of expenses incurred on the subsidiary’s behalf by its parent be determined, and what disclosure is required in the financial statements? |
| **Interpretive Response** | The staff expects any expenses clearly applicable to the subsidiary to be reflected in its income statements. However, the staff understands that in some situations a reasonable method of allocating common expenses to the subsidiary (e.g., incremental or proportional cost allocation) must be chosen because specific identification of expenses is not practicable. In these situations, the staff has required an explanation of the allocation method used in the notes to the financial statements along with management’s assertion that the method used is reasonable.

In addition, since agreements with related parties are by definition not at arms length and may be changed at any time, the staff has required footnote disclosure, when practicable, of management’s estimate of what the expenses (other than income taxes and interest discussed separately below) would have been on a stand alone basis, that is, the cost that would have been incurred if the subsidiary had operated as an unaffiliated entity. The disclosure has been presented for each year for which an income statement was required when such basis produced materially different results. |
### Excerpt from SAB Topic 1.B (continued)

<table>
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</tr>
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<tbody>
<tr>
<td>Interpretive response</td>
<td><strong>Question 3:</strong> What are the staff’s views with respect to the accounting for and disclosure of the subsidiary’s income tax expense?</td>
</tr>
<tr>
<td></td>
<td>Recently, a number of parent companies have sold interests in subsidiaries but have retained sufficient ownership interests to permit continued inclusion of the subsidiaries in their consolidated tax returns. The staff believes that it is material to investors to know what the effect on income would have been if the registrant had not been eligible to be included in a consolidated income tax return with its parent. Some of these subsidiaries have calculated their tax provision on the separate return basis, which the staff believes is the preferable method. Others, however, have used different allocation methods. When the historical income statements in the filing do not reflect the tax provision on the separate return basis, the staff has required a pro forma income statement for the most recent year and interim period reflecting a tax provision calculated on the separate return basis.36</td>
</tr>
<tr>
<td>Question</td>
<td><strong>Question 4:</strong> Should the historical income statements reflect a charge for interest on intercompany debt if no such charge had been previously provided?</td>
</tr>
<tr>
<td>Interpretive response</td>
<td>The staff generally believes that financial statements are more useful to investors if they reflect all costs of doing business, including interest costs. Because of the inherent difficulty in distinguishing the elements of a subsidiary’s capital structure, the staff has not insisted that the historical income statements include an interest charge on intercompany debt if such a charge was not provided in the past, except when debt specifically related to the operations of the subsidiary and previously carried on the parent’s books will henceforth be recorded in the subsidiary’s books. In any case, financing arrangements with the parent must be discussed in a note to the financial statements. In this connection, the staff has taken the position that, where an interest charge on intercompany debt has not been provided, appropriate disclosure would include an analysis of the intercompany accounts as well as the average balance due to or from related parties for each period for which an income statement is required. The analysis of the intercompany accounts has taken the form of a listing of transactions (e.g., the allocation of costs to the subsidiary, intercompany purchases, and cash transfers between entities) for each period for which an income statement was required, reconciled to the intercompany accounts reflected in the balance sheets.</td>
</tr>
</tbody>
</table>

---

36 ASC paragraph 740-10-30-27 states: “The consolidated amount of current and deferred tax expense for a group that files a consolidated tax return shall be allocated among the members of the group when those members issue separate financial statements ... The method adopted ... shall be systematic, rational, and consistent with the broad principles established by [ASC 740-10]. A method that allocates current and deferred taxes to members of the group by applying [ASC 740-10] to each member as if it were a separate taxpayer meets those criteria.”
### Excerpt from SAB Topic 1.B (continued)

<table>
<thead>
<tr>
<th>Facts</th>
<th>A company (the registrant) operates as a subsidiary of another company (parent). Certain expenses incurred by the parent on behalf of the subsidiary have not been charged to the subsidiary in the past. The subsidiary files a registration statement under the Securities Act of 1933 in connection with an initial public offering.</th>
</tr>
</thead>
</table>
| Question | **Pro forma financial statements and earnings per share**  
Question: What disclosure should be made if the registrant's historical financial statements are not indicative of the ongoing entity (e.g., tax or other cost sharing agreements will be terminated or revised)? |
| Interpretive response | The registration statement should include pro forma financial information that is in accordance with Article 11 of Regulation S-X and reflects the impact of terminated or revised cost sharing agreements and other significant changes. |
| Question | **Other matters**  
What is the staff's position with respect to dividends declared by the subsidiary subsequent to the balance sheet date? |
| Interpretive response | The staff believes that such dividends either be given retroactive effect in the balance sheet with appropriate footnote disclosure, or reflected in a pro forma balance sheet. In addition, when the dividends are to be paid from the proceeds of the offering, the staff believes it is appropriate to include pro forma per share data (for the latest year and interim period only) giving effect to the number of shares whose proceeds were to be used to pay the dividend. A similar presentation is appropriate when dividends exceed earnings in the current year, even though the stated use of proceeds is other than for the payment of dividends. In these situations, pro forma per share data should give effect to the increase in the number of shares which, when multiplied by the offering price, would be sufficient to replace the capital in excess of earnings being withdrawn. |
Appendix B

Table 1: financial statement requirements in Rule 3-05 for completed business acquisitions (excerpted from SEC Regulation S-X Section 210.3-05)

<table>
<thead>
<tr>
<th>If the greatest of the three calculations</th>
<th>Financial statements required</th>
</tr>
</thead>
<tbody>
<tr>
<td>Does not exceed 20%</td>
<td>No financial statements required</td>
</tr>
<tr>
<td>Exceeds 20% but not 40%</td>
<td>Financial statements for the most recent fiscal year (audited) and the latest required interim period (unaudited) that precedes the acquisition, and the corresponding interim period of the preceding year (unaudited)</td>
</tr>
<tr>
<td>Exceeds 40% but not 50%</td>
<td>Financial statements for the two most recent fiscal years (audited) and the latest required interim period (unaudited) that precedes the acquisition, and the corresponding interim period of the preceding year (unaudited)</td>
</tr>
</tbody>
</table>
| Exceeds 50%                              | Financial statements for full three\(^{37}\) years (audited) and the latest required interim period (unaudited) that precedes the acquisition, and the corresponding interim period of the preceding year (unaudited)  
Exception: Financial statements for the earliest of the three fiscal years may be omitted if net revenues of the acquired business in its most recent fiscal year are less than $100 million. |

\(^{37}\) Only two years would be required if a registrant qualifies as a smaller reporting company or an emerging growth company.
### Table 2: Financial Statement Requirements for an Initial Registration Statement (Excerpted from the SEC Division of Corporation Finance FRM Section 2070.11)

| Year 1 (Most Recent Fiscal Year) | Businesses not included for at least 9 months in the registrant’s financial statements: | May exclude pre-acquisition financial statements to the extent that the sum of their highest significance levels does not exceed 10%.  
Thus, identify completed and probable acquisitions whose highest level of significance sums to 10% or less. If there is more than one combination of entities whose highest level of significance sums to 10% or less, the registrant may choose one combination. Financial statements for this combination may be omitted.  
For all other completed and probable acquisitions, the registrant must present at least 9 months of audited financial statements for each acquisition with no gap or overlap between the acquired business’ pre-acquisition audited periods and the registrant’s post-acquisition audited periods. |
|---|---|---|
| Year 2 (Preceding Fiscal Year) | Businesses not included for at least 21 months in the registrant’s financial statements: | May exclude pre-acquisition financial statements to the extent that the sum of their highest significance levels does not exceed 20%.  
Add to combination of acquisitions selected by the registrant that had a combined highest level of significance of 10% or less additional completed and probable acquisitions such that the combined highest level of significance sums to 20% or less.  
For all other completed and probable acquisitions that were not included in the registrant’s combination of completed and probable acquisitions whose highest level of significance sums to 20% or less, present at least 21 months of audited financial statements for each acquisition with no gap or overlap between the acquired business’ pre-acquisition audited periods and the registrant’s post-acquisition audited periods. |
| Year 3 (Second Preceding Fiscal Year) | Businesses not included for at least 33 months in the registrant’s financial statements: | May exclude pre-acquisition financial statements to the extent that the sum of their highest significance levels does not exceed 40%.  
Add to the registrant’s combination of acquisitions that had a combined highest level of significance of 20% or less additional completed and probable acquisitions such that the combined highest level of significance sums to 40% or less.  
For all other completed and probable acquisitions that were not included in the registrant’s combination of completed and probable acquisitions whose highest level of significance sums to 40% or less, present at least 33 months of audited financial statements for each acquisition with no gap or overlap between the acquired business’ pre-acquisition audited periods and the registrant’s post-acquisition audited periods. |
Appendix C
(excerpted from the SEC Regulation S-X Section 210.1-02)

The term *significant subsidiary* means a subsidiary, including its subsidiaries, which meets any of the following conditions:

1. The registrant’s and its other subsidiaries’ investments in and advances to the subsidiary exceed 10 percent of the total assets of the registrant and its subsidiaries consolidated as of the end of the most recently completed fiscal year (for a proposed combination between entities under common control, this condition is also met when the number of common shares exchanged or to be exchanged by the registrant exceeds 10 percent of its total common shares outstanding at the date the combination is initiated); or

2. The registrant’s and its other subsidiaries’ proportionate share of the total assets (after intercompany eliminations) of the subsidiary exceeds 10 percent of the total assets of the registrants and its subsidiaries consolidated as of the end of the most recently completed fiscal year; or

3. The registrant’s and its other subsidiaries’ equity in the income from continuing operations before income taxes of the subsidiary exclusive of amounts attributable to any noncontrolling interests exceeds 10 percent of such income of the registrant and its subsidiaries consolidated for the most recently completed fiscal year.
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