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FASB Issues Guidance on Profits Interest Awards

Overview

On March 21, 2024, the FASB issued ASU 2024-01,[1] which clarifies how an entity determines whether a profits interest or similar award (hereafter a "profits interest award") is (1) within the scope of ASC 718[2] or (2) not a share-based payment arrangement and therefore within the scope of other guidance.

Background

In October 2018, the FASB received an agenda request related to providing specific guidance on whether a profits interest award should be accounted for as a share-based payment arrangement under ASC 718 or in a manner similar to a cash bonus or profit-sharing arrangement under ASC 710[3] or other ASC topics. The agenda request noted that the absence of such guidance has resulted in diverse accounting for these awards.

Connecting the Dots

Nonpublic entities such as limited partnerships, limited liability companies, or similar pass-through entities may grant special classes of equity, frequently in the form of profits interest awards. Given the absence of authoritative guidance on determining the scope of these awards, entities have used interpretive guidance to help them evaluate an award's characteristics.[4] While the legal and economic form of such awards can vary, they have historically been accounted for on the basis of their substance. If an award has the characteristics of an equity interest, it represents a

1 FASB Accounting Standards Update (ASU) No. 2024-01, *Scope Application of Profits Interest and Similar Awards*.
2 FASB Accounting Standards Codification (ASC) Topic 718, *Compensation — Stock Compensation*.
3 ASC 710, *Compensation — General*.
4 For example, Section 2.6 of Deloitte's Roadmap *Share-Based Payment Awards* provides interpretive guidance on the scope of profits interest awards.

substantive class of equity and would therefore be accounted for under ASC 718; however, an award that is, in substance, a performance bonus or a profit-sharing arrangement would be accounted for as such in accordance with other U.S. GAAP (e.g., typically ASC 710 and ASC 450[5] for employee arrangements).

In response to the agenda request, the FASB's Private Company Council (PCC) formed a working group in August 2020 to assess whether there were pervasive practice-related issues associated with accounting for profits interest awards. At various meetings, the PCC and the PCC Technical Agenda Consultation Group discussed the issue of scope and other related matters as well as research and outreach performed by the FASB staff.

At the April 2022 PCC meeting, the PCC submitted for the Board's consideration an example illustrating how an entity would apply the scope guidance in ASC 718 in determining whether to account for a profits interest award under ASC 718. On the basis of the FASB staff's research and outreach, the PCC determined that the scope application issue was not limited to private companies because (1) certain public companies could be required to account for profits interest awards that remain outstanding if they filed a Form S-1 with the SEC and (2) the profits interest awards could, in certain situations, remain outstanding after an initial public offering (e.g., in an "Up-C" structure). The PCC therefore suggested that the Board add a project on profits interest awards to its technical agenda, which the Board did in December 2022.

Main Provisions of the ASU

The ASU adds Example 10: Profits Interest and Similar Awards (reproduced in the appendix to this *Heads Up*) to ASC 718-10-55. Example 10 includes Cases A through D, which are discussed in ASC 718-10-55-138 through 55-148. The new illustration shows how an entity should apply the guidance in ASC 718-10-15-3 to determine whether a profits interest award is within the scope of ASC 718 (see discussion below). The ASU also improves the clarity and operability of the guidance in ASC 718-10-15-3.

The guidance in ASU 2024-01 applies to all entities that issue profits interest awards as compensation to employees or nonemployees in exchange for goods or services.

Cases A Through D in Example 10

As outlined in ASC 718-10-55-139, the following assumptions apply to all four cases in Example 10:

- Entity X (a partnership) had only Class A units outstanding before June 1, 20X1.
- On June 1, 20X1, Class B incentive units were granted to employees of a subsidiary of Entity X.
- "An exit event may include an initial public offering, a change in control, or a liquidation of Entity X's assets."

Cases A and B

Entity X determines that the Class B units in Cases A and B are within the scope of ASC 718 because the Class B units meet the condition outlined in ASC 718-10-15-3(a). Under ASC 718-10-15-3(a), the guidance in ASC 718 applies to a grantor that issues (or offers to issue) shares, share options, or other equity instruments to an employee or nonemployee in exchange for goods or services or as consideration payable to a customer.

[5] ASC 450, *Contingencies*.

Case A — Profits Interest Within the Scope of ASC 718

In Case A, ASC 718-10-55-140 specifies that the Class B units cliff vest at the end of three years of service or fully vest upon an exit event if the grantee is still providing services to Entity X. Upon an exit event, the grantee would retain the vested Class B units or, if the Class B units are settled through an exit event, Entity X would distribute proceeds to the Class B unit holders on a pro rata basis along with the Class A units once the Class A unit holders have received distributions equal to a predetermined distribution threshold established on the grant date of the Class B units.

ASC 718-10-55-141 states that in the evaluation of whether the condition in ASC 718-10-15-3(a) is met, the following facts indicate that Entity X is offering to issue shares or other equity instruments and that the Class B units are therefore within the scope of ASC 718:

- The Class B units "vest upon three years of service or an exit event."
- Holding the vested Class B units gives the grantee "the right to participate in the residual interest of Entity X through periodic distributions, upon an exit event, or upon settlement proportionate to ownership of Class B units of Entity X in accordance with the distribution waterfall described in [ASC] 718-10-55-140(a)."

Case B — Profits Interest Within the Scope of ASC 718

In Case B, ASC 718-10-55-142 states that the Class B units vest only upon an exit event. When such exit event occurs, the grantee would retain the vested Class B units in a manner similar to the grantee in Case A. Alternatively, if the Class B units are settled through an exit event, Entity X would distribute proceeds to the Class B unit holders on a pro rata basis with the Class A units once the Class A unit holders have received distributions equal to a predetermined distribution threshold established on the grant date of the Class B units. In addition, the Class B units are eligible to participate in nonforfeitable operating distributions on the grant date.

ASC 718-10-55-143 states that in the evaluation of whether the condition in ASC 718-10-15-3(a) is met, the following facts indicate that Entity X is offering to issue shares or other equity instruments and that the Class B units are therefore within the scope of ASC 718:

- The Class B units vest upon an exit event.
- Holding the vested Class B units gives the grantee "the right to participate in the residual interest of Entity X through periodic distributions, upon an exit event, or upon settlement proportionate to ownership of Class B units of Entity X in accordance with the distribution waterfall described in [ASC] 718-10-55-142(a)."

Connecting the Dots

Paragraph BC3 of the ASU notes that while "profits interest" is not a defined term in the ASC master glossary, IRS Revenue Procedure 93-27 defines it as a "partnership interest other than a capital interest." As described in paragraph BC3, profits interest generally represent legal-form equity. Thus, the profits interest issued in Cases A and B are presumed to represent legal-form equity of Entity X in the evaluation of whether the Class B units meet the scope criterion in ASC 718-10-15-3(a) or are, in substance, a performance bonus or profit-sharing arrangement that would be accounted for in accordance with other U.S. GAAP.

In paragraph BC16 of the ASU, the Board discusses its decision not to clarify whether the legal form of an award is determinative in the application of ASC 718 or other guidance. The Board stated that it did so because of "potential unintended consequences, such as suggesting that the scope of guidance applied to an award should be based solely or predominantly on its legal form rather than on a complete evaluation of all information." Given that the characteristics of profits interest awards can vary, entities should evaluate the specific facts to determine whether such awards that are legal-form equity meet the scope condition in ASC 718-10-15-3(a).

One of the key considerations in determining whether a profits interest award constitutes a substantive class of equity is the ability to retain the residual interest in the entity upon vesting, even after termination. In both Case A and Case B, the grantee can retain a residual interest in Entity X upon satisfaction of the vesting condition. While the assumptions presented in Cases A and B support a conclusion that the Class B units are within the scope of ASC 718, entities should consider all facts and circumstances. Paragraph BC26 of the ASU states that the illustrative example is not exhaustive, and entities should exercise judgment and consider all relevant information when determining whether a profits interest award should be accounted for under ASC 718.

While Example 10 highlights common fact patterns for profits interests, there may be other relevant facts not covered in Case A or Case B that an entity should consider. For instance, a legal entity with no substantive operations or underlying net assets that is established solely to distribute a cash pool through a profits interest arrangement would be more akin to a performance bonus or a profit-sharing arrangement than a profits interest award accounted for under ASC 718.

Cases C and D

The Class B units in Cases C and D are phantom share units and do not represent legal-form equity of Entity X. They also do not entitle the grantee to receive equity of Entity X. Therefore, Entity X evaluates the Class B units to determine whether they are within the scope of ASC 718-10-15-3(b)(1). The guidance in ASC 718-10-15-3(b)(1) applies to entities that incur liabilities to an employee or nonemployee in exchange for goods or services or as consideration payable to a customer. Such amounts must also be based, at least in part, on the price of the entity's shares or other equity instruments.

Case C — Phantom Share Units Within the Scope of ASC 718

In Case C, ASC 718-10-55-145 states that the grantee of the Class B phantom share units is only eligible to receive cash upon an exit event. If such an event occurs, the Class B phantom share units are cash-settled on the basis of their fair value, which is calculated by reference to the price of the Class A units of Entity X as determined on the date of the exit event. Further, to receive any proceeds, the grantee must be providing services when the exit event occurs.

ASC 718-10-55-146 states that in the evaluation of whether the condition in ASC 718-10-15-3(b)(1) is met, Entity X has incurred a liability to the grantee that is based, at least in part, on the price of Entity X's shares and that the Class B phantom share units are therefore within the scope of ASC 718.

Case D — Phantom Share Units Not Within the Scope of ASC 718

In Case D, ASC 718-10-55-147 states that the grantee of the Class B phantom share units is only eligible to participate in Entity X's operating distributions equal to 1 percent of the preceding fiscal year's net income after the grantee provides three years of services. Further, the grantee is not eligible to participate in any proceeds upon an exit event, and the Class B phantom share units are forfeitable upon the grantee's termination for any reason at any time.

ASC 718-10-55-148 states that in the evaluation of whether the criteria in ASC 718-10-15-3(b)(1) and 15-3(b)(2) are met, the following facts indicate that the Class B phantom share units are not within the scope of ASC 718:

- "[T]he proceeds received by the grantee related to operating distributions are based on an operating metric (1 percent of the preceding fiscal year's net income) of Entity X and are not based, at least in part, on the price of Entity X's shares."
- "[T]here is no circumstance in which Entity X would be required to issue its equity shares or other equity instruments."

Connecting the Dots

Cases C and D

Compared with Cases A and B, the Class B units in Cases C and D are phantom share units. Entity X is therefore not offering to issue shares, share options, or other equity instruments that meet the criterion in ASC 718-10-15-3(a) related to scope. Thus, the evaluation of the Class B phantom share units issued in Cases C and D focuses on whether the Class B phantom share units meet the scope criterion in ASC 718-10-15-3(b) or are, in substance, a performance bonus or profit-sharing arrangement that should be accounted for in accordance with other U.S. GAAP.

In Case C, the grantee is, upon an exit event, entitled to receive proceeds that are based on the price of the Class A units, which represent equity of Entity X. Accordingly, the Class B phantom share units represent liabilities to employees for which the cash settlement is based, at least in part, on the price of Entity X's shares. By contrast, the grantee in Case D cannot, after an exit event, participate in distributions that are based on the price of the Class A units, but it can participate in operating distributions equal to 1 percent of the preceding fiscal year's net income. While the Class B phantom share units in Case C include a cash settlement provision under which, upon an exit event, the price is based on the price of the Class A units, the Class B phantom share units in Case D entitle the grantee to proceeds that are based on a fixed percentage of an operating metric. Thus, the Class B phantom share units fail to meet the criterion in ASC 718-10-15-3(b).

Application of the Guidance in Example 10

As discussed above, Example 10 adds to U.S. GAAP an illustration of how an entity should apply the guidance in ASC 718-10-15-3 to the assumptions in Cases A through D to determine whether the Class B units are within the scope of ASC 718 or are subject to other guidance. Since such guidance was not previously included within U.S. GAAP, the ASU is likely to reduce the diversity in practice associated with an entity's scope assessments in circumstances that are similar to those described in the four cases. In the absence of other relevant factors, however, the conclusions reached in the four cases would be consistent with those that an entity might reach by applying the nonauthoritative interpretations that many entities apply today, including the guidance in Section 2.6 of Deloitte's Roadmap *Share-Based Payment Awards*.

Effective Date and Transition

Effective Date

For public business entities (PBEs), the ASU's amendments are effective for fiscal years beginning after December 15, 2024, including interim periods within those years. For all entities other than PBEs, the ASU's amendments are effective for fiscal years beginning after

December 15, 2025, including interim periods within those years. Early adoption is permitted. If an entity intends to adopt the amendments in an interim period, it must do so as of the beginning of the fiscal year that includes that interim period.

Transition

Entities can apply the ASU's amendments either "(1) retrospectively to all prior periods presented in the financial statements or (2) prospectively to profits interest and similar awards granted or modified on or after the date at which the entity first applies the amendments."

If prospective application is elected, an entity must disclose "the nature of and reason for the change in accounting principle."

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Appendix — Example 10

Example 10 in ASU 2024-01 is reproduced below for reference.

ASC 718-10

Example 10: Profits Interest and Similar Awards

55-138 This Example illustrates how an entity should apply the guidance in paragraph 718-10-15-3 to determine whether a profits interest or similar award is a share-based payment arrangement and is within the scope of this Topic or is not a share-based payment arrangement and, therefore, is within the scope of other Topics. The guidance in this Example is limited to the application of paragraph 718-10-15-3 and does not address how to apply other Sections of this Topic, including recognition, classification, initial measurement, subsequent measurement, other presentation matters, and disclosure.

55-139 Cases A, B, C, and D share the following assumptions:

a. Entity X is a partnership. Before June 1, 20X1, Entity X had Class A units outstanding. On June 1, 20X1, Entity X grants Class B incentive units to employees of a subsidiary of Entity X in exchange for services.
b. An exit event may include an initial public offering, a change in control, or a liquidation of Entity X's assets.

Case A: Award Is a Share-Based Payment Arrangement

55-140 Additional assumptions are as follows:

a. The Class B units are profits interest units that are subordinated to the Class A units because after vesting they participate pro rata with the Class A units once the holders of the Class A units have received distributions equal to a predetermined distribution threshold established on the grant date of the Class B units.
b. The Class B units cliff vest at the end of three years of service.
c. Upon an exit event, the Class B units vest immediately if a grantee is still providing services to the subsidiary of Entity X. Upon such an event, the grantee would retain the vested Class B units, or if Class B units are settled through the exit event, Entity X would distribute proceeds to the Class B unit holders in the same manner as is described in (a).
d. If a grantee of the Class B units terminates employment with the subsidiary of Entity X (whether voluntarily, upon death, disability, or retirement or at the election of Entity X for reasons other than cause), any unvested Class B units will be forfeited for no consideration. If a grantee of the Class B units terminates employment after vesting, the grantee retains ownership of the vested Class B units, but upon the grantee's termination of employment, Entity X has a call right to repurchase the Class B units. If the call right is exercised, Entity X would pay the grantee of the Class B units an amount of cash equal to the fair value of the Class B units on the call date.

55-141 Entity X evaluates the conditions in paragraph 718-10-15-3 to determine whether to account for the Class B units by applying the guidance in this Topic. The Class B units meet the condition in paragraph 718-10-15-3(a) because both of the following indicate that Entity X is offering to issue shares or other equity instruments:

a. Either upon three years of service or an exit event, the grantor will have received the agreed-upon consideration (that is, the service will have been provided and the performance condition will have been met, if applicable) and the award will vest.
b. Holding the vested Class B units provides the grantee with the right to participate in the residual interest of Entity X through periodic distributions, upon an exit event, or upon settlement proportionate to ownership of Class B units of Entity X in accordance with the distribution waterfall described in paragraph 718-10-55-140(a).

Therefore, Entity X would account for the Class B units by applying the guidance in this Topic.

Case B: Award Is a Share-Based Payment Arrangement

55-142 Additional assumptions are as follows:

a. The Class B units are profits interest units that are subordinated to the Class A units because once granted, they participate pro rata with the Class A units once the holders of the Class A units have received distributions equal to a predetermined distribution threshold established on the grant date of the Class B units.
b. The grantee of the Class B units is eligible to begin participating in nonforfeitable operating distributions at the grant date.
c. The Class B units only vest upon an exit event. Upon such an event, the grantee would retain the vested Class B units, or if Class B units are settled through the exit event, Entity X would distribute proceeds to the Class B unit holders in the same manner as is described in (a). Class B units are forfeitable upon the grantee's termination for any reason at any time before an exit event.

ASC 718-10 (continued)

55-143 Entity X evaluates the conditions in paragraph 718-10-15-3 to determine whether to account for the Class B units by applying the guidance in this Topic. The Class B units meet the condition in paragraph 718-10-15-3(a) because both of the following indicate that Entity X is offering to issue shares or other equity instruments:

a. Upon an exit event, the grantor will have received the agreed-upon consideration (that is, the service will have been provided and the performance condition will have been met) and the award will vest.
b. Holding the vested Class B units provides the grantee with the right to participate in the residual interest of Entity X through periodic distributions, upon an exit event, or upon settlement proportionate to ownership of Class B units of Entity X in accordance with the distribution waterfall described in paragraph 718-10-55-142(a).

Therefore, Entity X would account for the Class B units by applying the guidance in this Topic.

55-144 The grantee of the Class B units is not entitled to retain the units if the grantee ceases to provide services before an exit event. Upon termination of employment before an exit event, the grantee of the Class B units would forfeit all rights to future distributions and would forfeit Class B units for no consideration. Entity X would account for the grantee's right to participate in nonforfeitable operating distributions in accordance with paragraph 718-10-55-45.

Case C: Award Is a Share-Based Payment Arrangement

55-145 Additional assumptions are as follows:

a. The Class B units do not entitle the grantee to receive equity instruments of Entity X. This type of unit is often referred to as a phantom share unit.
b. The grantee of the Class B units is not eligible to participate in distributions in the ordinary course of business.
c. The grantee of the Class B units is eligible to receive cash upon an exit event. Upon an exit event, the Class B units vest immediately and must be settled in cash on the basis of the fair value of the Class B units. The fair value of the Class B units is calculated by reference to the price of Class A units of Entity X as determined at the date of the exit event.
d. The grantee of the Class B units must be providing services when the exit event occurs to receive any proceeds, and the Class B units are forfeitable upon the grantee's termination for any reason at any time before an exit event.

55-146 Entity X evaluates the conditions in paragraph 718-10-15-3 to determine whether to account for the Class B units by applying the guidance in this Topic. The Class B units do not meet the condition in paragraph 718-10-15-3(a) because they do not entitle the grantee to receive shares or other equity instruments of Entity X; therefore, Entity X is not issuing, or offering to issue, shares, share options, or other equity instruments. However, the condition in paragraph 718-10-15-3(b)(1) is met because the cash proceeds received by the grantee upon settlement in an exit event are based, at least in part, on the price of Entity X's shares. Therefore, Entity X would account for the Class B units by applying the guidance in this Topic.

Case D: Award Is Not a Share-Based Payment Arrangement

55-147 Additional assumptions are as follows:

a. The Class B units do not entitle the grantee to receive equity instruments of Entity X. This type of unit is often referred to as a phantom share unit.
b. The grantee of the Class B units is eligible to participate in operating distributions made by Entity X equal to 1 percent of the preceding fiscal year's net income. The grantee of the Class B units is eligible to begin participating in these operating distributions after three years of service.
c. The grantee of the Class B units is not eligible to participate in any proceeds distributed upon an exit event.
d. The Class B units are forfeitable upon the grantee's termination for any reason at any time (including after the grantee has rendered three years of service).

55-148 Entity X evaluates the conditions in paragraph 718-10-15-3 to determine whether to account for the Class B units by applying the guidance in this Topic. The Class B units do not meet the condition in paragraph 718-10-15-3(a) because they do not entitle the grantee to receive shares or other equity instruments of Entity X; therefore, Entity X is not issuing or offering to issue shares, share options, or other equity instruments. In addition, the condition in paragraph 718-10-15-3(b)(1) is not met because the proceeds received by the grantee related to operating distributions are based on an operating metric (1 percent of the preceding fiscal year's net income) of Entity X and are not based, at least in part, on the price of Entity X's shares. Furthermore, the condition in paragraph 718-10-15-3(b)(2) is not met because there is no circumstance in which Entity X would be required to issue its equity shares or other equity instruments. Therefore, Entity X would not apply the guidance in this Topic to account for the Class B units and, instead, would account for the Class B units in accordance with other Topics.

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