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FASB Proposes Clarifications to Scope Guidance on Profits Interest Awards

Overview

On May 11, 2023, the FASB issued a [proposed ASU](#)¹ that would clarify how an entity determines whether it is required to account for profits interest awards (and similar awards) in accordance with ASC 718² or other guidance. Comments on the proposed ASU are due by July 10, 2023.

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 710³ 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 interests. While the legal and economic form of these awards can vary, they should be accounted for on the basis of their substance. If an award has the characteristics of an equity interest, it represents a substantive class of equity and should 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 450⁴ for employee

¹ FASB Proposed Accounting Standards Update (ASU), *Scope Application of Profits Interest Awards*.

² FASB Accounting Standards Codification (ASC) Topic 718, *Compensation — Stock Compensation*.

³ ASC 710, *Compensation — General*.

⁴ ASC 450, *Contingencies*.

arrangements). See [Section 2.6](#) of Deloitte's Roadmap *Share-Based Payment Awards* for more discussion of profits interest awards and other awards issued by pass-through entities.

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 profit interest awards. The PCC and the PCC Technical Agenda Consultation Group discussed at various meetings 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 illustrative example of scope application requirements and transition guidance. The PCC also recommended that the scope guidance not be 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 further suggested that the Board add a project on profits interest to its technical agenda.

Accordingly, in December 2022, the Board added to its technical agenda a project on developing an illustrative example of how an entity would apply the scope guidance in ASC 718 to determine whether to account for a profits interest award under ASC 718.

Main Provisions of the Proposed ASU

The proposed ASU would add to U.S. GAAP an example illustrating four scenarios in which an entity applies the scope criteria in ASC 718-10-15-3 to determine whether to account for a profits interest award in accordance with ASC 718. The illustrative example is intended to reduce (1) complexity in the determination of whether a profits interest award is subject to the guidance in ASC 718 and (2) diversity in practice.



Connecting the Dots

The proposed ASU's example illustrates two scenarios in which profits interest awards are within the scope of ASC 718 and two in which they are outside of it. Paragraph BC19 of the proposal states that the example is "not intended to be all-inclusive." Thus, an entity "should consider all relevant facts and circumstances when determining whether a profits interest award should be accounted for in accordance with Topic 718."

Proposed Effective Date and Transition

Effective Date

The effective date will be determined after the Board considers stakeholder feedback on the proposal.

Transition

Entities would apply the proposed amendments either "(1) retrospectively to all prior periods presented in the financial statements or (2) prospectively to profits interest awards granted or modified on or after the effective date."

If prospective application is chosen, an entity would have to disclose "the nature of and reason for the change in accounting principle."

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