BDO BULLETIN

FASB CLARIFIES SCOPE APPLICATION OF PROFITS INTEREST AND SIMILAR AWARDS

MARCH 2024

SUMMARY

The FASB recently issued ASU 2024-01 (“the ASU”) to clarify the scope application of profits interest and similar awards by adding illustrative guidance in ASC 718, *Compensation - Stock Compensation*.

The amendments in the ASU apply to all reporting entities that account for profits interest awards as compensation to employees or nonemployees in return for goods or services.

BACKGROUND

The term “profits interest” is not explicitly defined in U.S. GAAP. Rather, IRS Revenue Procedure (Rev. Proc.) 93-27 defines a profits interest as a “partnership interest other than a capital interest.” Unlike a capital interest, which provides rights to existing net assets of an entity, a profits interest only provides rights to future profits and/or equity appreciation of an entity. This distinction, along with other terms, conditions, and characteristics of profits interests, often complicates accounting decisions for profits interests, leading to diversity in practice on whether to account profits interests under ASC 718 or other U.S. GAAP (for example, ASC 710).

MAIN PROVISIONS

The ASU introduces an illustrative example with four different fact patterns that demonstrate how an entity would apply the scope guidance in paragraph 718-10-15-3 to a profits interest or similar award with certain features.

The following table[1] lists each of the fact patterns (Case A through D) in the illustrative example and summarizes their respective conclusions on the application of the scoping guidance in paragraph 718-10-15-3:

[1] The term “Units” used in the table below refers to the Class B Units as described in Example 10 of the ASU.

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CASE EXAMPLE	CONCLUSION - IN SCOPE OF 718?	BASIS FOR CONCLUSION
Case A	Yes	The Units in both Case A and Case B are determined to be share-based payment awards because they allow grantees to participate in the residual interest of the entity, either immediately upon vesting or upon an exit event. Therefore, they meet the condition in paragraph 718-10-15-3(a).
Case B	Yes	
Case C	Yes	The Units in Case C do not entitle the grantee to equity instruments of the entity and therefore, do not meet the condition in paragraph 718-10-15-3(a). However, they meet the condition in paragraph 718-10-15-3(b)(1) because the cash proceeds upon an exit event are based on the price of the entity's shares.
Case D	No, apply other U.S. GAAP	The Units fail to meet either of the conditions in paragraph 718-10-15-3 because: ▶ The Units do not entitle the grantee to equity instruments of the entity. ▶ The proceeds are not based on the price of entity's shares. ▶ There is no situation in which the entity would be required to issue its equity shares or other equity instruments.

BDO INSIGHT - NO CHANGE TO THE CLASSIFICATION GUIDANCE IN ASC 718

The ASU clarifies how to determine whether profits interest and similar awards are in the scope of ASC 718 by adding illustrative guidance. However, concluding that an award is in the scope of ASC 718 as determined under the ASU should not be interpreted to mean that it is equity-classified without considering the classification guidance in ASC 718. That is, if a profits interest or similar award is in the scope of ASC 718 based on the amendments in the ASU, an entity should next evaluate whether the award is equity- or liability-classified in paragraphs ASC 718-10-25-6 through 25-19A.

In addition to adding the illustrative guidance, the ASU modified the language in paragraph 718-10-15-3 to improve its clarity and operability. However, this amendment does not change the intent of that guidance, nor how it should be applied.

EFFECTIVE DATES AND TRANSITION

The following table summarizes the effective dates and transition for the ASU:

	PUBLIC BUSINESS ENTITIES	ALL OTHER ENTITIES
EFFECTIVE DATE	Fiscal years beginning after December 15, 2024, and interim periods within those annual periods.	Fiscal years beginning after December 15, 2025, and interim periods within those annual periods.
EARLY ADOPTION	Permitted for all financial statements that have not yet been issued or made available for issuance.	
TRANSITION	Retrospective to all prior periods presented. Entities must make disclosure requirements pursuant to ASC 250-10-50-1 through 50-3. *or* Prospective to profits interest and similar awards granted or modified on or after the date of adoption. Entities must disclose the nature of and reason for the change in accounting principle.	

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Link to the ASU

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The experienced professionals in BDO's Accounting Advisory practice can help navigate the complexities of applying U.S. GAAP and adopting new accounting guidance.

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