

March 22, 2024

FASB ISSUES ACCOUNTING STANDARDS UPDATE ON APPLYING SCOPE OF STOCK-BASED COMPENSATION TO PROFITS INTEREST AWARDS

The Financial Accounting Standards Board (FASB) on March 21, 2024 issued Accounting Standards Update (ASU) 2024-01 to provide further clarity regarding whether profits interest and similar awards (profits interest awards) are within the scope of stock-based compensation guidance as defined in Accounting Standards Codification (ASC) Topic 718.

The issued ASU incorporates revisions in response to stakeholder feedback to FASB's original proposal, outlined in our previous Alert Letter in May 2023. As with the original proposal, the ASU introduces four illustrative examples detailing different fact patterns and key considerations designed to demonstrate circumstances under which a profits interest award would fall within or outside the scope of ASC Topic 718.

The first two scenarios identify profits interest awards as subordinate unit classes subject to stock-based compensation guidance within ASC Topic 718. This classification is due to their eligibility for pro rata distribution proportionate to ownership either before or at an exit event. These scenarios closely align with the original proposed ASU issued in May 2023, with revisions emphasizing the awards would be considered equivalent to equity instruments.

The third case has been revised to fall within the scope of ASC Topic 718. It presents a phantom share unit that qualifies as a liability award eligible to receive distributions based, at least in part, on the entity's fair value (such as another equity instrument or net assets). This scenario highlights phantom share units solely settled in cash upon an exit event, with its value determined in reference to the company's stock.

The final example illustrates profits interest awards that are outside the scope of ASC Topic 718 and also presents phantom share units that are settled in cash upon an exit event. However, these awards involve distributions linked to specific operating metrics, such as net income, and do not subject the recipient to changes in the fair value of the entity. In such cases, the profits interest awards would be accounted similar to a cash bonus or profit-sharing arrangement under ASC Topic 710, which deals with compensation in general.

It is important to note that ASU 2024-01 does not address the application of other stock-based compensation guidance within ASC Topic 718 to profits interest awards, such as recognition, initial measurement, disclosure, and so on.

The term *profits interest* is not explicitly defined within Generally Accepted Accounting Principles (GAAP), but Internal Revenue Service (IRS) Revenue Procedure 93-27 differentiates *profits interest* from *capital interests*. Capital interests grant the right to receive existing net assets, while profits interest awards allow participation in future profits and/or equity appreciation of the entity. Profits interests typically come with transfer restrictions, do not confer voting rights, and do not necessitate an initial monetary investment from the recipient. Additionally, they may be subject to forfeiture provisions, performance or service conditions, or exit events like an initial public offering (IPO), change in control or liquidation of the entity's assets.

As a reminder, ASC Topic 718 governs all share-based payment transactions with employees and nonemployees (referred to collectively as grantees) in which a company acquires goods or services by issuing company stock, or by incurring liabilities that are based on the fair value of the company's stock or are settled by issuing company stock.

ASU 2024-01 becomes effective for public business entities for fiscal years beginning after December 15, 2024, and for all other entities for fiscal years after December 15, 2025.

Early adoption of the ASU is permitted for both unissued interim and annual financial statements. Upon adoption, a company may choose to apply the ASU:

- Retrospectively to all prior periods presented in the financial statements, requiring the application to all profits interest awards for those periods, or
- Prospectively to profits interest awards granted or modified on or after the adoption date; meaning previous profits interest award accounting would remain consistent with the previously applied methodology

Both approaches necessitate disclosure in the financial statements' footnotes, either adhering to the retrospective application for the period of adoption or a description of the nature of and reason for the change in accounting principle for prospective implementation.

General questions about this summary can be addressed to Stafford Schmidt in our New York City office at 212.294.0105 or by email at stafford.schmidt@fwcook.com; or to Thomas M. Haines in our Chicago office at 312.332.0910 or by email at thomas.haines@fwcook.com. Specific questions should be referred to the company's professional accountants. Copies of this summary and other published materials are available on our website at www.fwcook.com. A complete summary of ASC Topic 718 can be found [here](#).