

May 19, 2023

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

The Financial Accounting Standards Board (FASB) released a proposed Accounting Standards Update (ASU) on May 11, 2023, with the aim of clarifying 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 need for this clarification arose due to the observed diversity in practices among stakeholders.

The proposed ASU provides four illustrative examples to assist in determining whether a profits interest award should be subject to the guidance in ASC Topic 718. Two of these examples demonstrate situations in which profits interest distributions are entirely or partially dependent on an entity's value (such as company stock or net assets) and would fall within the scope of ASC Topic 718. Conversely, the remaining two examples highlight distributions linked to operating metrics, such as net income, and would be considered outside the scope of ASC Topic 718. In such cases, the profits interest awards would be accounted for 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 the proposed ASU 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.

Each of the four examples illustrate profits interest units that vest within three years or at an exit event. The first two case examples fall within scope of ASC Topic 718 due to the fact the vested units provide the right to participate in residual net assets or distributions proportionate to unit ownership, thereby exposing the grantee to changes in the fair value of the entity. The remaining two cases demonstrate profits interest awards that fall outside the scope of ASC Topic 718. These awards involve distributions tied to a specific operating metric, such as net income, either before or at an exit event. Consequently, these profits interests do not subject the recipient to changes in the fair value of the entity.

Profits interest typically incur capital gains tax upon distribution, except in specific circumstances. These exceptions include profits interests that are associated with a substantially certain or predictable income stream from partnership assets, profits interests that are disposed of by the recipient within two years of receipt, or interests in a publicly traded entity.

Profits interests are generally not categorized as non-qualified deferred compensation (NQDC). However, it is important to note that ensuring compliance with the Internal Revenue Code (IRC) may require a 409A valuation.

The FASB Exposure Draft issued on May 11, 2023 also presents stakeholders with specific questions to ensure that the proposed ASU offers clear and effective guidance that can be consistently applied. These questions mean to assess the adequacy of the four proposed illustrations in determining the scope of profits interest awards and anticipate any challenges that may arise in applying the proposed guidance. FASB is also requesting comment on whether the proposed ASU would be applied either retrospectively to all prior periods presented in the financial statements or prospectively to profits interest awards granted or modified on or after the effective date. Interested parties have the opportunity to submit their feedback to the FASB until the conclusion of the comment period on July 10, 2023.

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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](mailto: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](mailto: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](http://www.fwcook.com). A complete summary of ASC Topic 718 can be found [here](#).