Snapshot

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FASB clarifies ASC 718's scope for profits interests

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In March 2024, the FASB issued ASU 2024-01, *Scope Application of Profits Interest and Similar Awards*, which adds illustrative examples to U.S. GAAP that demonstrate how the scoping guidance in ASC 718 applies to profits interest or similar awards granted to employees and nonemployees as compensation. While not defined in U.S. GAAP, *profits interest awards* typically align a grantee's compensation with the entity's operating performance and entitle the grantee to participate in an entity's future profits or equity appreciation.

The amendments apply to all entities that grant profits interest or similar awards and are effective for annual periods, including interim periods within those annual periods, beginning after December 15, 2024 for public business entities and beginning after December 15, 2025 for all other entities. Early adoption is permitted, and the amendments may be applied either retrospectively or prospectively.

Application of scoping guidance in ASC 718 to profits interest awards

The FASB recently issued ASU 2024-01, which adds illustrative examples that demonstrate how the scoping guidance in ASC 718-10-15-3 applies to profits interest or similar awards (collectively referred to as "profits interest awards"). Typically, entities grant profits interest awards to their employees and nonemployees in exchange for goods or services, and those awards align the grantee's compensation with an entity's operating performance. The amendments are intended to reduce existing diversity in practice so that, after adoption, profits interest awards with similar terms will be more consistently accounted for within the scope of either ASC 718, *Compensation – Stock Compensation,* or other Topics, such as ASC 710, *Compensation – General.*

Grant Thornton insight: Why scoping matters – ASC 718 versus ASC 710

There can be significant differences, for example, in accounting for an award that is within the scope of ASC 718 compared to ASC 710. For instance, ASC 718 requires the grantor to follow the valuation methodologies outlined in ASC 718, which often require entities to engage a third-party valuation expert. On the other hand, ASC 710 requires management to determine if it is probable that a performance condition will be met and, once probable, to make its best estimate of the amount of the payment to the grantee. Further, the disclosure requirements in ASC 718 and ASC 710 differ significantly. These are just two examples of why it is important for management to appropriately classify its awards using the guidance in ASC 718 or in other Topics, such as ASC 710.

The term *profits interest* is not defined in U.S. GAAP, but these interests differ from other equity interests that provide the investor with rights to an entity's existing net assets. In contrast, a holder of a profits interest award generally only participates in the grantor's future profits or equity appreciation, and often only after other interest holders of senior classes of equity recover their investment plus a specified return. While not codified, Paragraph 5 in the Basis for Conclusions of ASU 2024-01 notes that common characteristics of profits interest awards include, but are not limited to, the following:

a. Management's intent is to award the recipient compensation upon a sale, liquidity event (for example, an IPO or other change of control), or final liquidation of the entity.

b. Awards have a relatively high distribution hurdle. Recipients of such awards often will not receive distributions in the normal course of business because of the high distribution threshold required and the level of subordination. Recipients are often more likely to receive residual value upon a sale or liquidity event.

c. Awards frequently have a performance condition linked to a change in control, a recapitalization, an IPO, or another liquidity event.

d. Awards may or may not have a service condition required for vesting.

e. Forfeiture and repurchase provisions vary significantly. Some awards are forfeited upon separation from the entity for any reason, while other awards include a call option exercisable at fair market value, calculated value, or some other amount.

f. Awards typically (1) do not grant voting rights, (2) contain various transfer restrictions, and (3) require no initial monetary investment by the grantee.

g. Profits interest awards may qualify for beneficial tax treatment by the recipient.

Amendments improve operability of scoping guidance in ASC 718

In accordance with ASC 718-10-15-3B, an entity applies the guidance in ASC 718-10-15-3 to determine whether profits interest awards are within the scope of ASC 718. The amendments in ASU 2024-01 modify the structure of ASC 718-10-15-3 to improve its clarity and operability, but are otherwise not intended to change the substance of the existing guidance.

In accordance with ASC 718-10-15-3, an award is within the scope of ASC 718 if the grantor acquires goods or services from a grantee by either

(a) Issuing (or offering to issue) its shares, share options, or other equity instruments; or

(b) Incurring liabilities whose (1) amount is based, at least in part, on the price of the entity's shares or other equity instruments, or (2) settlement requires, or may require, issuance of the entity's shares or other equity instruments.

ASC 718-10-15-3

The guidance in the Compensation—Stock Compensation Topic applies to all share-based payment transactions in which a grantor acquires goods or services to be used or consumed in the grantor's own operations or provides consideration payable to a customer by either of the following:

a. Issuing (or offering to issue) its shares, share options, or other equity instruments to an employee or a nonemployee

b. Incurring liabilities to an employee or a nonemployee that meet either of the following conditions:

   1. The amounts are based, at least in part, on the price of the entity's shares or other equity instruments. (The phrase *at least in part* is used because an award of share-based compensation may be indexed to both the price of an entity's shares and something else that is neither the price of the entity's shares nor a market, performance, or service condition.)

   2. The awards require or may require settlement by issuing the entity's equity shares or other equity instruments.

ASC 718-10-15-3B

An entity shall apply the guidance in paragraph 718-10-15-3 to determine whether a profits interest or similar award is within the scope of this Topic. Paragraphs 718-10-55-138 through 55-148 illustrate how the guidance in paragraph 718-10-15-3 applies to common features in a profits interest or similar award.

New illustrative examples

The amendments in ASU 2024-01 add several examples to illustrate how the scoping guidance in ASC 718-10-15-3 applies to common features in a profits interest award, as further discussed below. All scenarios assume that the grantor is a partnership and has existing Class A units outstanding when the grantor issues profits interest awards in the form of Class B incentive units to employees in exchange for services.

Profits interest awards within the scope of ASC 718

Cases A and B illustrate the application of ASC 718-10-15-3(a) when an entity is issuing, or offering to issue, its shares or other equity instruments to the grantee.

Case A

In Case A, the Class B units are profits interest awards that:

- Are subordinated to Class A units in that, after vesting, the grantee participates pro rata with the Class A unitholders after those holders have received distributions equal to a predetermined distribution threshold established on the grant date of the Class B units.
- Cliff vest at the end of three years of service. The grantee is entitled to retain any vested Class B units if the grantee terminates his or her employment for any reason other than for cause, but will forfeit any unvested units for no consideration upon termination.
- Are subject to the grantor's right to call the awards upon a grantee's termination. That is, the grantor may repurchase the grantee's vested Class B units for an amount of cash equal to the fair value of the Class B units as of the call date.
- Vest immediately if a grantee is still providing services as of the date of an exit event (for example., an IPO, a change in control, or a liquidation). Upon the exit event, the grantee will either retain the vested units or, if the Class B units are settled through the exit event, receive proceeds in accordance with the same distribution threshold noted in the first bullet.

Case A concludes that the Class B units meet ASC 718-10-15-3(a) and, therefore, are within the scope of ASC 718. The entity is offering to issue its shares or other equity instruments to the grantee, because the award will vest after either three years of service or an exit event. In addition, upon vesting, the grantee has the right to participate in the residual interest of the entity through periodic distributions, upon an exit event, or upon settlement in an amount that is proportionate to the grantee's ownership interests in the entity based on the specified distribution waterfall (that is, in accordance with the contractual distribution schedule, holders of Class B units will participate in pro rata distributions with Class A unitholders after those holders receive a specified amount of distributions).

Case B

In Case B, the Class B units are profits interest awards that:

- Are subordinated to Class A units in that, once granted, the grantee participates pro rata with the Class A unitholders after those holders have received distributions equal to a predetermined distribution threshold established on the grant date of the Class B units.
- Allow the grantee, upon the grant date, to participate in nonforfeitable operating distributions.
- Vest only upon an exit event. Upon the exit event, the grantee will either retain the vested units or, if the Class B units are settled upon the exit event, receive proceeds in accordance with the same distribution threshold noted in the first bullet.
- Are forfeitable upon the grantee's termination for any reason at any time before an exit event.

Case B concludes that the Class B units meet ASC 718-10-15-3(a) and, therefore, are within the scope of ASC 718. The entity is offering to issue its shares or other equity instruments to the grantee, because the award will vest upon an exit event. In addition, the grantee has the right to participate in the residual interest of the entity through periodic distributions, upon an exit event, or upon settlement in an amount that is proportionate to the grantee's ownership interests in the entity based on the specified distribution waterfall.

Further, the entity would account for the grantee's right to participate in nonforfeitable operating distributions in accordance with ASC 718-10-55-45.

Case C

Case C illustrates the application of ASC 718-10-15-3(b)(1) when an entity incurs a liability to a grantee but the amount is based, at least in part, on the price of the entity's shares or other equity instruments.

In Case C, the Class B units:

- Do not entitle the grantee to receive equity instruments, such that Class B units may be considered to be phantom share units.
- Do not allow the grantee to participate in distributions during the ordinary course of business.
- Vest only upon an exit event, at which time, the Class B units must be settled in cash in an amount that is based on the fair value of the Class B units, assuming the grantee is still providing services as of the exit event. The fair value of the Class B units is calculated by referring to the price of the entity's Class A units as of the date of the exit event.
- Are forfeitable upon the grantee's termination for any reason at any time before an exit event.

Case C concludes that the Class B units meet ASC 718-10-15-3(b)(1) and, therefore, are within the scope of ASC 718. While the entity is not issuing, or offering to issue, its equity to the grantee, the entity is incurring a liability whose cash settlement amount is based, at least in part, on the price of the entity's shares.

Profits interest awards not within the scope of ASC 718

Case D

Case D illustrates when a profits interest award does not meet any of the conditions in ASC 718-10-15-3 and, therefore, is within the scope of other U.S. GAAP, such as ASC 710.

In Case D, the Class B units:

- Do not entitle the grantee to receive equity instruments, such that Class B units may be considered to be phantom share units.
- Entitle the grantee to participate in operating distributions made by the entity equal to 1 percent of the preceding fiscal year's net income once the grantee has provided three years of service. The grantee is not eligible to participate in any distributions upon an exit event.
- Are forfeitable upon the grantee's termination for any reason at any time, even after the grantee has provided three years of service.

Case D concludes that the Class B units are not within the scope of ASC 718. The entity is not issuing, or offering to issue, its equity to the grantee, so ASC 718-10-15-3(a) is not met. In addition, ASC 718-10-15-

3(b)(1) is not met, given that operating distributions to the grantee are based on the entity's net income in the preceding fiscal year and, therefore, are not based, at least in part, on the price of the entity's shares. Lastly, ASC 718-10-15-3(b)(2) is not met, because the entity is not required to issue its shares or other equity instruments. As a result, the entity would not apply ASC 718 to the Class B units and would instead apply other U.S. GAAP, such as ASC 710.

Grant Thornton insight: Do the amendments in ASU 2024-01 change practice?

In our view, we do not believe the amendments in ASU 2024-01 will significantly change practice for typical profits interest awards issued by entities to incentivize their employees and nonemployees. In our experience, most profits interest awards fall squarely within the scope of ASC 718-10-15-3, as the awards either (a) vest upon a liquidity event and are settled by issuing equity instruments or paying cash in an amount based, at least in part, on the price of the entity's shares or other equity instruments, or (b) vest upon a specified number of years of service and vested units are callable by the entity at fair market value upon the grantee's termination for reasons other than cause.

ASC 718 not amended beyond scoping guidance

The amendments in ASU 2024-01 do not impact other guidance in ASC 718 beyond the changes to demonstrate how the scoping guidance in ASC 718-10-15-3 applies to profits interest awards. Therefore, the amendments in ASU 2024-01 do not impact the classification within ASC 718 (that is, whether an award is equity-classified or liability-classified in accordance with ASC 718-10-25-6 through 25-19A), recognition, initial measurement, subsequent measurement, other presentation matters, and disclosure requirements.

Effective date and transition

The amendments in ASU 2024-01 apply to all reporting entities that account for profits interest awards as compensation to employees or nonemployees.

For public business entities, the amendments are effective for annual periods beginning after December 15, 2024 and for interim periods within those periods. For all other entities, the amendments are effective for annual periods beginning after December 15, 2025 and for interim periods within those annual periods. Early adoption is permitted for both interim and annual financial statements that have not yet been issued or been made available for issuance. If an entity adopts the amendments in an interim period, it should apply the amendments as of the beginning of the annual period that includes that interim period.

The amendments must be applied either (1) retrospectively to all prior periods presented or (2) prospectively to profits interest awards granted or modified on or after the effective date.

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