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EARLY IMPRESSIONS

FASB's Guidance on applicability of ASC 718 to Profits Interest and Similar Awards (Topic 718)

April 2024

Foreword

Certain entities grant special awards in the form of profits interests, for example profits interest which may entitle the interest holder to a portion of any distributions made, once senior interest holders obtain a specified return. Sometimes it can be difficult to determine whether profits interest should be accounted for as Share based payment under ASC 718- Compensation—Stock Compensation or as a performance bonus/ profit-sharing arrangement under ASC 710- Compensation—General, or other Topics.

On March 21, 2024, the FASB issued an Accounting Standard Update 2024-01 **("ASU 2024-01" or "ASU")**, which clarifies by adding examples to illustrate the scope application of ASC 718 on how an entity determines whether a profits interest or similar awards (hereinafter also referred to as **"profits interest awards"**) is (1) within the scope of ASC 718 or (2) not a share-based payment arrangement and therefore within the scope of other guidance.

ASU also states that the illustrative example is not exhaustive, and entities should exercise judgment and consider all relevant information when determining whether a profits interest award should be accounted for under ASC 718.

This publication provides an overview of the key accounting considerations related to classification assessment and consequential accounting of profits interest awards along with the main provisions of ASU.

We sincerely hope you find the enclosed publication informative. We will be happy to participate in any discussions required to clarify our views, which are enclosed in the attached publication. We look forward to hearing from you.

Thank you.

Yours faithfully

For Uniqus Consultech Inc.

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Background

Certain entities provide employees or nonemployees with profits interest awards to align compensation with an entity's operating performance and provide those holders with the opportunity to participate in future profits and/or equity appreciation of the entity. The term profits interest is not defined in GAAP but differentiates those interests from capital interests held by investors that provide those holders with rights to the existing net assets in a partnership or similar entity (for instance, a limited liability company [LLC]). Because profits interest holders only participate in future profits and/or equity appreciation and have no rights to the existing net assets of the partnership, it becomes difficult to determine whether a profits interest award should be accounted for as a share-based payment arrangement (Topic 718) or similar to a cash bonus or profit-sharing arrangement (Topic 710, Compensation—General, or other Topics).

Correct accounting depends upon the correct classification of awards. While the legal and economic forms of these awards can vary, they should be accounted for based on their substance. An award that has the characteristics of an equity interest 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 in accordance with other guidance as applicable to employee arrangement such as ASC 710. In other words, profits interest awards may be akin to equity interests or profit sharing/bonus arrangements. In the absence of any authoritative guidance, judgment is required to make that assessment, which in practice, has resulted in diverse accounting for these awards.

FASB, in its efforts to improve the operability of the guidance in ASC 718-10-15-3, has issued ASU 2024-01 adding examples to illustrate the scope application of ASC 718. The illustrative example includes four fact patterns to demonstrate how an entity would apply the scope guidance in paragraph 718-10-15-3 to determine whether profits interest awards should be accounted for in accordance with ASC 718. ASU also amends certain language in the Scope and Scope Exceptions Section of Topic 718 to improve its clarity and operability without changing the guidance.

ASU 2024-01 guidance applies to all entities that issue profits interest awards as compensation to employees or non-employees in exchange for goods or services. The ASU is likely going to be relevant for certain PBEs also who (a) have not yet completed an IPO but have filed or furnished financial statements with or to the U.S. Securities and Exchange Commission (SEC) or (b) less commonly, in situations in which profits interest awards have remained outstanding following an IPO.

Classification assessment and consequential accounting of profits interest awards-Key accounting consideration

A What are profits interest awards?

IRS Revenue Procedure 93-27 defines a profits interest as an interest in a partnership that would receive no proceeds if the partnership were immediately liquidated at the time of receipt of the partnership interest. Profits interests are contrasted with capital interests, which are partnership interests whose holders would receive proceeds if the entity were immediately liquidated. A profits interest provides the holder with rights to a share of only the partnership's future profits and/or equity appreciation and does not provide the holder with rights to the existing net assets of the partnership.

The characteristics of a profits interest award can vary such that in some instances, the award may be more akin to other types of equity awards (such as stock options), but in other instances, the award may be more akin to a performance bonus or profit-sharing arrangement. Common terms and characteristics of profits interest awards include but may not be limited to:

a. Management's intent is to award the recipient compensation upon a sale, liquidity event (for example, an initial public offering [IPO] or other change of control), or final liquidation of the entity or awards having an explicit performance condition linked to liquidity event.

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

c. Awards may or may not have an explicit service condition required for vesting.

d. 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.

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

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

B Classification assessment of profits interest awards

Step 1:

Determining whether profits Interest Awards are profit-sharing arrangements or performance bonus.

ASC 718-10-15-3 provides guidance for the scope applicability of ASC 718 to stock compensation awards. As per the principles of ASC 718-10-15-3, if it is determined that an award (or the underlying security) has predominantly equity characteristics (even if junior to other classes of equity interests), it is subject to the scope of the ASC 718. In other words, if payment under the arrangement is required to be settled in or based, at least in part, on the price of the entity's shares or other equity instruments, the arrangement is in the scope of ASC 718. ASU also amended the language of ASC 718-10-15-3 (as reproduced below) to improve its clarity and operability without changing the guidance.

Existing guidance	Amended guidance
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 issuing (or offering to issue) its shares, share options, or other equity instruments or by incurring liabilities to an employee or a nonemployee that meet either of the following conditions: a. 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.)	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 non-employee. b. Incurring liabilities to an employee or a nonemployee that meet either of the following conditions:

Existing guidance	Amended guidance
b. The awards require or may require settlement by issuing the entity's equity shares or other equity instruments.	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.

One of the key considerations in determining whether profits interest awards are profit-sharing arrangements or performance bonuses is the employee's rights upon voluntary termination. If an employee is only entitled to share in profits while providing employee service and forfeits those rights upon termination of employment, the arrangement would generally be considered akin to a profit-sharing arrangement or performance bonus, not an equity award.

The following provides an indicative list of the factors which may be considered to determine whether an arrangement is a share-based arrangement **that should be accounted for under ASC Topic 718 or not.** The list is not all-inclusive-:

✓	✗

Primary indicators:
• The legal form of security is equity.
• Rights commensurate with an ownership interest in the Entity:
  • Liquidation rights (Claims to the residual net assets of the entity upon dissolution or liquidation proportionate to other equity holders)
  • Distributions proportionate to ownership interest (participation in the residual returns of the entity's net assets in a manner consistent with equity ownership)
  • Participation in fair value fluctuations of the Entity.
• Retention of vested interests on termination of service
Additional indicators which may also be considered when evaluating the substance of the arrangement:
• Initial investment required by the employee.
• Risk of loss of initial capital in the event of dissolution or liquidation of the company.
• Voting rights commensurate with ownership interest
• Interest is transferable after vesting.
• Management's intent is to provide the employee with an equity ownership interest in the Entity.
• Existence of Pre-emptive rights (right to maintain their proportionate ownership through potential future issuances of common stock)
• Existence of right or the obligation to participate proportionately with the controlling shareholder's exit (sometimes referred to as drag-along or tag-along rights).
	• Rights to share in distributions tied to continued employment. In the event of termination of employment:
	  • Automatic termination of any rights and/or return of units for no or nominal consideration.
	  • Repurchase features (puts/calls) based on a formula (e.g., a fixed multiple of EBITDA)
	  • A call option (option is with the entity) that provides for a fixed price or off-market (discounted) repurchase of the profits interest on cessation of employment.
	Note: The Entity's right to repurchase the profits interest at fair value is not considered an indicator of a profit sharing or deferred compensation plan.
	• Creditor-like features (e.g., fixed redemption date or a specified return)
	• Management's intent to provide a performance bonus by allowing employees to share in profits and distributions of the entity only during employment.
	• Profits interest used instead of cash bonuses for preferential tax treatment.

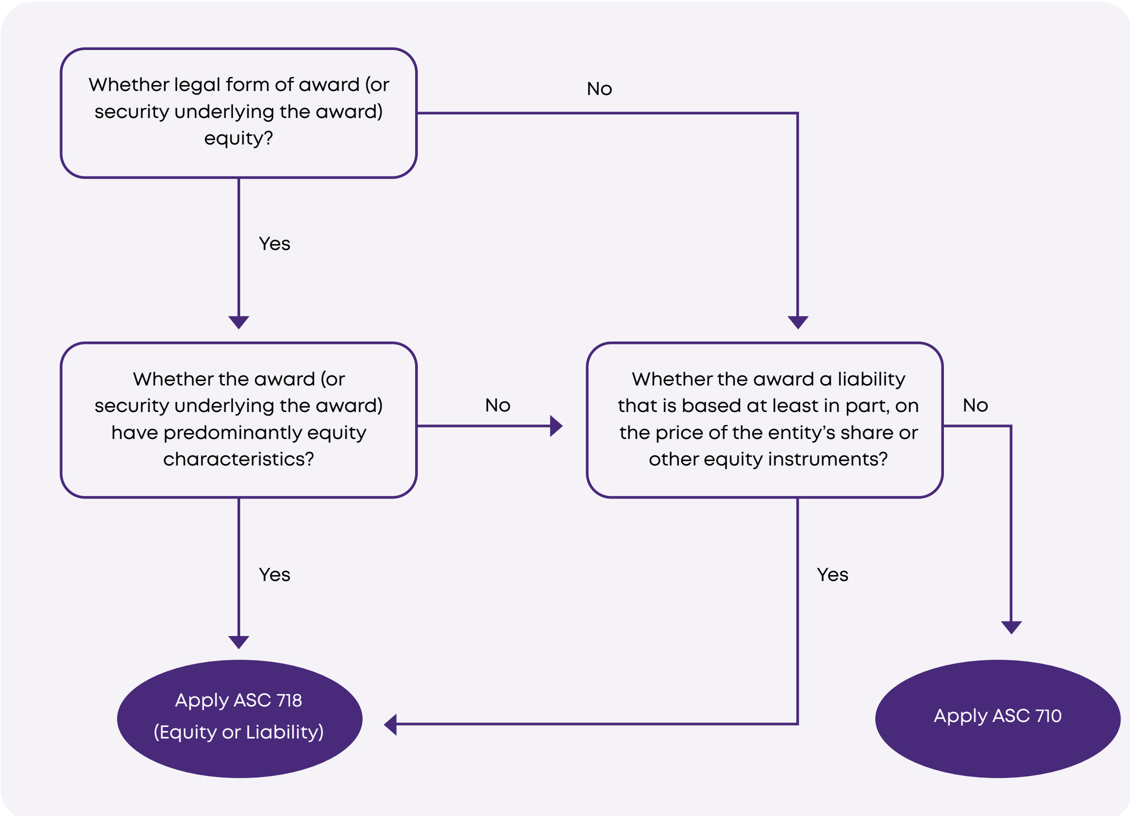
Step 2:

Profits interest awards not in the nature of profit-sharing arrangement or performance bonus to be classified as Equity or Liability.

The awards classified as within the scope of ASC 718 need to be further assessed as to whether features of the award result in the "Liability" or "Equity" classification. Key factors, which should be considered for such classification assessment include:

- The legal form of the instrument (to be classified as equity, it must be considered legal equity of the partnership or LLC)
- Participation features such as voting rights, distribution rights, and liquidation rights (i.e., to be classified as equity, the instrument must participate in the residual returns of the entity's net assets in a manner consistent with equity ownership)
- Transferability of the instrument
- Retention of vested interests upon termination of employment or when a nonemployee ceases to provide goods or services (liability classification is likely when vested interests are not retained upon termination)
- The settlement and repurchase features. (using the applicable guidance from EITF 00-23, Issue 23, which is still applied in practice)

Following flowchart summaries, the steps for classification assessment of awards granted to employees:



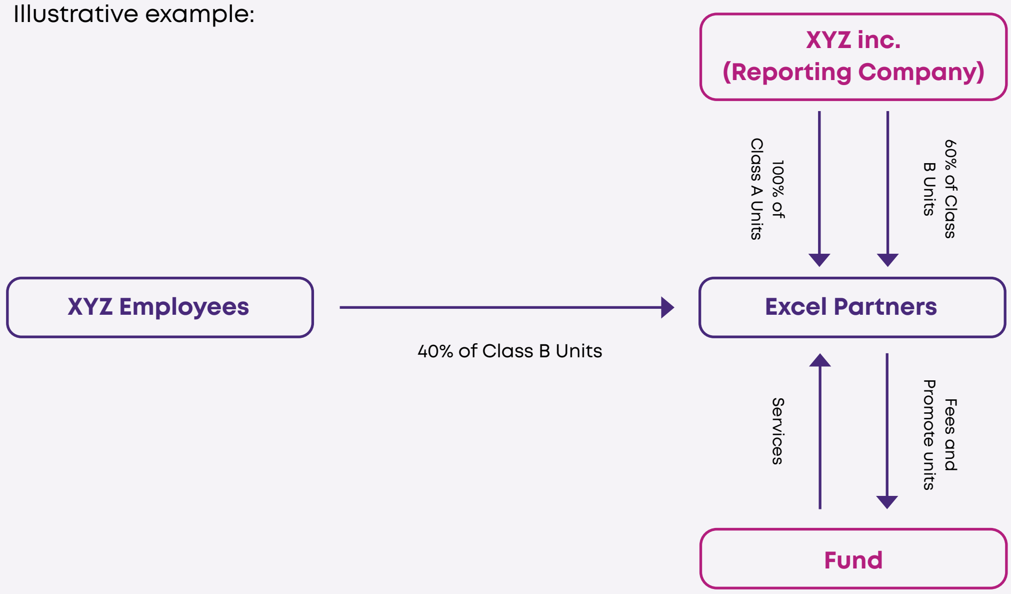
C Recognition and measurement principles of profits interest awards

Nature of Awards	Recognition and measurement principles
a. Profits interest awards classified as Employee Stock awards **(ASC 718)**	
i. Classified as Equity	• Measure the fair value of the award on the grant date. • Recognize compensation cost over the requisite service period. • No adjustment for subsequent changes in fair value.
ii. Classified as Liability	• Measure the fair value of the award on the grant date. • Recognize compensation cost over the requisite service period. • Remeasure the fair value of the award each reporting period until the award is settled. • True up compensation cost each reporting period for changes in fair value pro-rated for the portion of the requisite service period rendered. • Once vested (i.e., the requisite service period is complete), immediately recognize compensation cost for any changes in fair value. That remeasurement process continues until settlement.
b. Profits Interest Award that is, in substance, a profit-sharing arrangement or performance bonus **(ASC 810)**	Recognizing the liability and compensation cost as per the guidance of the deferred compensation plan • The present value of the obligation is fully accrued at the date the employee attains full eligibility for benefits. • If substantive future service is not required, the cost is generally required to be accrued at the grant date rather than over the remaining employment or service period. • If, however, the future payments require future services, then the charge to income would be based on the services rendered through the balance sheet date.

Main Principles of Examples added by amendments to Topic 718

The amendment adds Example 10: Profits Interest and Similar Awards to ASC 718-10-55. The Example includes Cases A through D, discussed in ASC 718-10-55-138 through 55-148, to improve the understandability of how an entity should apply the guidance in ASC 718-10-15-3 to determine whether a profits interest award is within the scope of ASC 718. The following example illustrates the guiding principles emanating from amendments:

Illustrative example:



Background

As part of the profit-sharing arrangement between the Fund and Excel Partners (EP), EP distributes 50% of the EP's return on investment if the fund returns exceed 10% of the investment. This additional capital distribution made by the EP is in the form of promote units. The promote units are distributed as follows if the fund returns exceed 10% of the investment.

Investors

60% to XYZ Inc.

40% to XYZ employees that invested in EP

Assumptions

On December 20X4, the EP distributes 100 % promote units to their investors.

The Entity makes a policy election to estimate the number of forfeitures -Estimated forfeiture rate for the unvested units	None expected
Grant-date fair value of promote units	**$10**

Scenario 1:

Promote units granted to the employee's cliff vest at the end of three years of service or fully vest upon an exit event if the grantee is still providing services. Upon an exit event, the grantee would retain the vested units, or if the units are settled through an exit event, EP would distribute proceeds to the unit holders on a pro-rata basis.

Scenario 2:

Employees are eligible to participate in nonforfeitable operating distributions on the grant date. Promote units vest only upon an exit event. When such an exit event occurs, the employees would retain the vested units. On settlement through an exit event, EP would distribute proceeds to the unit holders on a pro-rata basis.

Scenario 3:

Employees holding promote units can only receive cash upon an exit event. On exit event, promote units are cash-settled based on their fair value, which is calculated by reference to the price of the Class A equity units of EP as determined on the date of the exit event, provided an employee must be providing services when the exit event occurs.

Scenario 4:

Employees holding promote units are only eligible to participate in EP's operating distributions equal to 2 percent of the preceding fiscal year's net income after the employee provides three years of services. An employee is not eligible to participate in any proceeds upon an exit event. Units are forfeitable upon the employee's termination for any reason at any time.

Scenario 1 and Scenario 2: Residual interest in the entity upon vesting

Guiding principles in ASU	Conclusion
Profits interest awards, wherein holding the vested awards provides the grantee: • **Right to participate in the residual interest of Entity through periodic distributions, upon an exit event, or settlement proportionate to ownership of awards of Entity in accordance with the distribution waterfall.**	The Entity is offering to issue shares or other equity instruments; therefore, profits interest awards are within the scope of ASC 718 as per the principles of ASC 718-10-15-3(a).

As per the facts of the given scenarios, XYZ employees continue to retain a residual interest in EP upon satisfaction of the vesting condition. Therefore, promote units distributed to the XYZ employees for services rendered to XYZ Inc. would be considered as performance-based share-based payments for services rendered to XYZ and would be within the scope of ASC Topic 718.

Scenario 3: Cash settled awards by reference to the price of the entity's shares

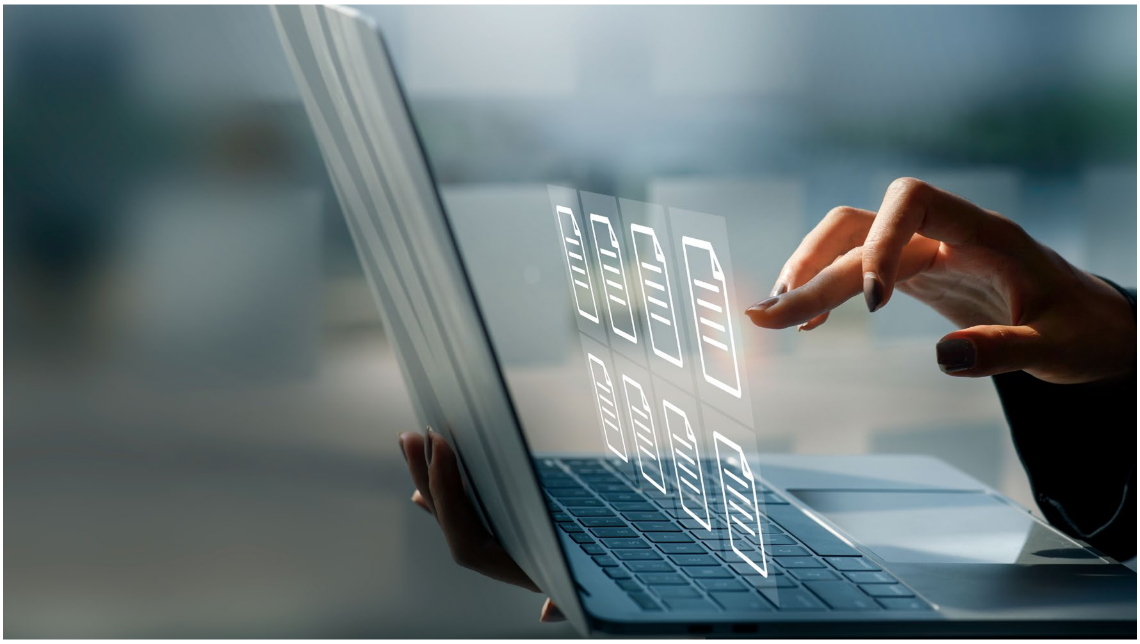
Guiding principles in ASU	Conclusion
Profits interest awards that are cash-settled (such as phantom share units) entitle the grantee to receive only the cash upon an exit event, wherein: • **The proceeds received by the grantee are based on awards' fair value, which is calculated by reference to the entity's shares price determined on the date of the exit event.**	The Entity has incurred a liability to the grantee that is based, at least in part, on the price of Entity's shares; therefore, the profits interest awards are within the scope of ASC 718 as per the principles of ASC 718-10-15-3(b)(1).

As per the facts of the given scenarios, XYZ employees holding promote units are entitled to receive proceeds that are based on the price of the entity's equity instrument. Therefore, promote units distributed to the XYZ employees for services rendered to XYZ Inc. would be considered as performance-based share-based payments for services rendered to XYZ and would be within the scope of ASC Topic 718.

Scenario 4: Cash settled awards by reference to the entity's operating metrics

Guiding principles in ASU	Conclusion
Profits interest awards that are cash-settled (such as phantom share units) entitle the grantee to receive only the cash while providing employee service and forfeits those rights upon termination of employment, wherein: • **The proceeds received by the grantee related to operating distributions based on an operating metric (such as 1 percent of the preceding fiscal year's net income) of Entity and are not based, at least in part, on the price of Entity X's shares.** • **There is no circumstance in which the Entity would be required to issue its equity shares or other equity instruments.**	Profits interest awards fail to meet the criterion in ASC 718-10-15-3(a) and ASC 718-10-15-3(b). Therefore, awards are not within the scope of ASC 718.

As per the facts of the given scenario, XYZ employees holding promote units are entitled to receive proceeds that are based on a fixed percentage of an operating metric, such as a percentage of the preceding fiscal year's net income, with no link to the price of shares or other equity instruments. Therefore, promote units distributed to the XYZ employees for services rendered to XYZ Inc. would not be considered as within the scope of ASC Topic 718.



Summary of the illustrations added in ASU as a new guidance

Example 10 - Cases A through D

The following assumptions apply to all four cases in Example 10:

- Entity X (a partnership) had only Class A units outstanding before June 1, 20X1.
- On June 1, 20X1, Class B incentive units were granted to employees of a subsidiary of Entity X.
- "An exit event may include an initial public offering, a change in control, or a liquidation of Entity X's assets."

AWARDS WITHIN SCOPE OF ASC 718

Cases	Guidance in the ASU	Implementation matters
A	• Class B units cliff vest at the end of three years of service or fully vest upon an exit event if the grantee still provides services to Entity X. • Upon an exit event, the grantee would retain the vested Class B units or if the Class B units are settled through an exit event, Entity X would distribute proceeds to the Class B unit holders on a pro-rata basis along with the Class A units once the Class A unit holders have received distributions equal to a predetermined distribution threshold established on the grant date of the Class B units.	Key considerations in determining whether a profits interest award is within the scope of ASC 718 include- • The ability of the grantee to retain the residual interest in the entity upon vesting, even after termination. In both Case A and Case B, the grantee can retain a residual interest in Entity X upon satisfaction of the vesting condition. Entities may require exercising the judgment and considering all relevant information to identify grantees' rights in the residual interest of the entity for vested units. **ASC 718-10-15-3(a).**
B	• The grantee of Class B units is eligible to participate in nonforfeitable operating distributions on the grant date. • Class B units vest only upon an exit event. When such an exit event occurs, the grantee would retain the vested Class B units.	

AWARDS WITHIN SCOPE OF ASC 718

Cases	Guidance in the ASU	Implementation matters
	• When the Class B units are settled through an exit event, Entity X would distribute proceeds to the Class B unit holders on a pro-rata basis with the Class A units once the Class A unit holders have received distributions equal to a predetermined distribution threshold established on the grant date of the Class B units	
C	• The grantee of the Class B phantom share units is only eligible to receive cash upon an exit event. • If such an event occurs, the Class B phantom share units are cash-settled based on their fair value, which is calculated by reference to the price of the Class A units of Entity X as determined on the date of the exit event. • Further, to receive any proceeds, the grantee must be providing services when the exit event occurs.	Key considerations in determining whether a profits interest award is within the scope of ASC 718 include- • Grantees have an entitlement to receive proceeds that are based on the price of the entity's equity instrument. In Case C, the proceeds received by the grantee are based on awards fair value, which is calculated by reference to the entity's shares price determined on the date of the exit event. Entities shall consider all relevant information to check if a cash settlement is based at least in parts on price of entity's shares or other equity instruments. **ASC 718-10-15-3(b)(1).**

	Cases	Guidance in the ASU	Implementation matters
AWARDS NOT WITHIN SCOPE OF ASC 718	D	• The Grantee of the Class B phantom share units is only eligible to participate in Entity X's operating distributions equal to 1 percent of the preceding fiscal year's net income after the Grantee provides three years of services. • The grantee is not eligible to participate in any proceeds upon an exit event. • Units are forfeitable upon the grantee's termination for any reason at any time.	Key considerations in determining profits interest awards are not within the scope of ASC 718 include- • Absence of right to participate in any proceeds distributed in exit event linked to the price of shares or other equity instruments, even though grantee can participate in operating distributions based on a fixed percentage of an operating metric such as percentage of the preceding fiscal year's net income. In Case D, the proceeds received by the grantee related to operating distributions based on an operating metric and not linked to the Entity's share price. Entities shall consider all relevant information to check if a cash settlement is based at least in parts on price of the Entity's shares or other equity instruments.

The examples added by the amendment provide application guidance for principles of ASC 718-10-15-3 to the assumptions in Cases A through D to determine whether the Class B units are within the scope of ASC 718 or are subject to other guidance. The amendment is likely to reduce complexity in the determination of whether a profits interest award is subject to the guidance in ASC 718 and will also reduce the diversity in practice associated with an entity's scope assessment in circumstances that are similar to those described in the four cases.

Reporting entities should exercise judgment and consider all relevant information when determining whether a profits interest award should be accounted for under ASC 718.

Effective date and transition

Effective date

	PBEs	Other entities
Annual periods – fiscal years beginning after	December 15, 2024	December 15, 2025
Interim periods – In fiscal years beginning after	December 15, 2024	December 15, 2025
Early adoption is permitted. If an Entity intends to adopt the amendments in an interim period, it must do so as of the beginning of the fiscal year that includes that interim period.		

Transition

Entities can apply the amendments either:

- retrospectively to all prior periods presented in the financial statements or
- prospectively to profits interest and similar awards granted or modified on or after the date at which the entity first applies the amendments.

If the prospective application is elected, an Entity must disclose "the nature of and reason for the change in accounting principle."

For more information on the amendment in ASU, see the **press release** on the FASB's Web site.

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