FASB Clarifies Profits Interest Accounting

On March 21, 2024, FASB issued Accounting Standards Update (ASU) 2024-01, *Scope Application of Profits Interest and Similar Awards*, to clarify the accounting guidance on profits interest. Due to the current lack of authoritative guidance, diversity in practice has arisen; entities most commonly analogize to treatment as a share-based payment (Accounting Standards Codification (ASC) 718) or a form of deferred compensation (ASC 710). ASU 2024-01 adds an illustrative example (with four fact patterns) to assist entities in determining whether a profits interest award should be accounted for under ASC 718. **FASB expects that this clarification may result in more profits interest awards being accounted for in accordance with ASC 718.**

Effective Dates	Public Business Entities	All Others
ASU 2024-01 (early adoption permitted)	Annual & interim periods beginning after December 15, 2024	Annual & interim periods beginning after December 15, 2025

Background

A profits interest provides an interest in a partnership's future profits and/or appreciation. It can be economically similar to stock options or stock appreciation rights. This award is designed to defer taxation and is often granted as an incentive to executives of private equity portfolio companies and other pass-through entities. The use of profits interests to reward performance is not available to corporations or associations that elect to be taxable as corporations or any other form of business entity not taxed as a partnership. Currently, profits interests are not defined in accounting guidance, but they are defined for tax purposes in Revenue Procedure 93-27. There are generally two types of partnership interests: capital interests and profits interests. A capital interest is an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership. This determination generally is made at the time of receipt of the partnership interest. A profits interest is a partnership interest other than a capital interest.

Capital Interests
- Past economic profits (net of losses)
- Past capital contributions (net of distribution)
- Would receive proceeds in an immediate liquidation

Profits Interests
- Future economic profits (net of losses)
- Receives nothing in an immediate liquidation

Current Guidance		
	ASC 710-10 Deferred Compensation	**ASC 718 Stock Compensation**
Classification	Liability	Equity or liability
Measurement	Present value of the benefits expected to be provided to the employee	Equity: Grant-date fair value Liability: Remeasured at fair value or intrinsic value each period
Recognition	The portion applicable to the current services is accrued each period (some guides suggest not accruing costs until "probable and reasonably estimable")	Recognized over requisite service period straight-line or using graded attribution model (accelerated recognition of compensation cost)

Diversity in Practice

Diversity in practice applies to both awards that meet the legal definition of a profits interest, as well as other awards that are economically similar, *e.g.*, share appreciation rights or phantom units that do not convey legal equity.

Because the term "profits interest" is not currently defined in GAAP, entities have taken a facts and circumstances approach to analyze if an arrangement should be covered by ASC 718, ASC 710, or other guidance. Common terms and characteristics of profits interest awards include but may not be limited to:

- Management's intent is to award the recipient compensation upon a sale, liquidity event, *i.e.*, an initial public offering (IPO) or other change of control, or final liquidation of the entity.
- 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.
- Awards frequently have an explicit performance condition linked to a change in control, recapitalization, IPO, or other liquidity event.
- Awards may or may not have an explicit service condition required for vesting.
- 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.
- Awards typically do not grant voting rights, contain various transfer restrictions, and require no initial monetary investment by the grantee.
- Profits interest awards may qualify the recipient for beneficial tax treatment.

The illustrative example is intended to help entities determine if ASC 718 applies to their unique fact patterns. If ASC 718 does not apply, entities would then defer to other guidance.

The new example is not intended to be all inclusive. Entities must still consider all relevant information and apply judgment.

Scope

Although this issue is most prevalent for private companies, most notably private equity portfolio companies, it also can impact certain public business entities (PBEs). For example, a PBE may have profits interest awards that remain outstanding when the entity has not yet completed an IPO but has filed or furnished financial statements to the SEC, or when profits interest awards remain outstanding following an IPO.

ASU 2024-01 applies to all reporting entities that account for profits interest awards as compensation to employees or nonemployees in return for goods or services.

Effective Date & Early Adoption

ASU 2024-01 is effective for PBEs for annual periods beginning after December 15, 2024 and interim periods within those annual periods. For entities other than PBEs, the ASU is effective for annual periods beginning after December 15, 2025 and interim periods within those annual periods.

Early adoption is permitted for both interim and annual financial statements that have not yet been issued or made available for issuance. For early adoption in an interim period, the change should be made as of the beginning of the annual period that includes that interim period.

Transition

An entity can apply the guidance either:

- Retrospectively to all prior periods presented in the financial statements, or
- Prospectively to profits interest awards granted or modified on or after the date the ASU is first applied, along with disclosure about the nature of and reason for the change in accounting principle

Conclusion

If you have any questions or need assistance, **FORVIS** can help. Our assurance team delivers extensive experience and skilled professionals to assist with your objectives. Our proactive approach includes candid and open communication to help address your financial reporting needs. At the end of the day, we know how important it is for you to be able to trust the numbers; our commitment to independence and objectivity helps provide the security and confidence you desire. Whether you are publicly traded or privately held, FORVIS can help provide an independent and objective view into your financial reporting. For more information, visit **forvis.com**.

Contributor

Anne Coughlan
Director
anne.coughlan@forvis.com