

To the Point

FASB – proposed guidance

FASB proposes guidance to clarify when profits interest awards are in the scope of ASC 718

The proposal is intended to reduce the complexity of accounting for profits interest awards and reduce diversity in practice.

What you need to know

- ▶ The FASB proposed adding an example to ASC 718 that would illustrate how an entity would apply the scope guidance to determine whether a profits interest award should be accounted for as a share-based payment arrangement under ASC 718 or another accounting standard.
- ▶ The proposal would apply to all reporting entities that grant profits interest awards or similar awards.
- ▶ Entities would apply the guidance retrospectively or prospectively.
- ▶ Comments are due by 10 July 2023.

Overview

The Financial Accounting Standards Board (FASB or Board) **proposed** adding an example to Accounting Standards Codification (ASC) 718¹ that would demonstrate how an entity would apply the scope guidance to determine whether profits interests and similar awards should be accounted for as share-based payment arrangements.

Some entities compensate employees or other service providers by granting profits interest awards. While the term “profits interest” is not defined in US GAAP, these awards generally give the grantee an opportunity to participate in future profits and/or equity appreciation of the entity but do not give them rights to existing net assets of the entity. The FASB noted that the characteristics of profits interests can vary such that the award may be akin to other types of equity awards, such as stock options, or to a bonus or profit-sharing arrangement.²

The proposal is intended to reduce the complexity in determining whether profits interests and similar awards are in the scope of ASC 718 and to reduce diversity in practice. Currently, entities evaluate the terms, conditions and characteristics of these awards and apply judgment to determine whether to account for them as share-based payment arrangements under ASC 718 or under other guidance (e.g., employee profit-sharing arrangements under ASC 710³). Stakeholders have indicated that there is diversity in practice, even when the facts are similar.

While profits interest awards are typically issued by private companies, the proposal would apply to all entities that issue these types of awards, including public business entities.

Key considerations

The proposal would add an example to ASC 718 that would describe four fact patterns and illustrate how an entity would evaluate the common terms and characteristics of profits interests and similar awards to reach a conclusion about whether an award meets the scope conditions in ASC 718-10-15-3.

The FASB said the proposed example is not intended to be all inclusive. As a result, entities would need to consider all relevant facts and circumstances when determining whether a profits interest award should be accounted for in accordance with ASC 718.

How we see it

The FASB said the proposal, if finalized, could result in more profits interest awards being accounted for under ASC 718. However, the Board said it does not anticipate that the proposal would result in a significant change for most entities because its outreach indicates that more entities have been concluding over time that profits interest awards should be accounted for in accordance with ASC 718.⁴

Effective date and transition

The guidance would provide an entity with the option to apply the guidance (1) retrospectively to all periods presented in the financial statements in accordance with ASC 250⁵ or (2) prospectively to profits interest awards granted or modified on or after the effective date with a disclosure that describes any change in accounting principle that resulted from the adoption of the proposed guidance change in accounting principle.

The FASB said it would determine the effective date and whether early adoption will be permitted after it considers stakeholder feedback on the proposal.

Endnotes:

- ¹ ASC 718, *Compensation – Stock Compensation*.
- ² Background Information and Basis for Conclusions paragraph BC5.
- ³ ASC 710, *Compensation – General*.
- ⁴ Background Information and Basis for Conclusions paragraphs BC9 and BC12.
- ⁵ ASC 250, *Accounting Changes and Error Corrections*.

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