

To the Point

FASB – final guidance

FASB clarifies when profits interest awards are in the scope of ASC 718

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

What you need to know

- ▶ The FASB issued final guidance to add an example to ASC 718 that illustrates how to 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 guidance applies to all reporting entities that grant profits interest awards or similar awards.
- ▶ For public business entities, the guidance is effective for fiscal years beginning after 15 December 2024 and interim periods within those fiscal years. For other entities, it is effective for fiscal years beginning after 15 December 2025 and interim periods within those fiscal years. Entities may apply the guidance retrospectively or prospectively. Early adoption is permitted.

Overview

The Financial Accounting Standards Board (FASB or Board) **amended**¹ the guidance in Accounting Standards Codification (ASC) 718² to add an example showing how to 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.³

The Accounting Standards Update (ASU) 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 710⁴). 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 guidance applies to all entities that issue these types of awards, including public business entities.

Key considerations

The ASU adds an example to ASC 718 that describes four fact patterns and illustrates how an entity evaluates 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 fact patterns are not intended to be all-inclusive and do not reflect scenarios requiring significant judgment to determine whether an arrangement meets the scope criteria in ASC 718.

How we see it

Entities still need to consider all relevant facts and circumstances when determining whether a profits interest award should be accounted for in accordance with ASC 718.

Effective date and transition

For public business entities, the guidance is effective for fiscal years beginning after 15 December 2024 and interim periods within those fiscal years. For all other entities, it is effective for fiscal years beginning after 15 December 2025 and interim periods within those fiscal years.

The guidance provides 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 the nature of and reason for the change in accounting principle that resulted from the adoption of the guidance.

Early adoption is permitted for both interim and annual financial statements that have not yet been issued or made available for issuance. An entity that adopts the guidance in an interim period will do so as of the beginning of the fiscal year that includes that interim period.

Endnotes:

- ¹ ASU 2024-01, *Compensation – Stock Compensation (Topic 718): Scope Application of Profits Interest and Similar Awards*.
- ² ASC 718, *Compensation – Stock Compensation*.
- ³ Background Information and Basis for Conclusions paragraph BC5.
- ⁴ ASC 710, *Compensation – General*.
- ⁵ ASC 250, *Accounting Changes and Error Corrections*.

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