FASB ACCOUNTING STANDARDS UPDATE

No. 2024-01
March 2024

Compensation—Stock Compensation (Topic 718)

Scope Application of Profits Interest and Similar Awards

An Amendment of the *FASB Accounting Standards Codification®*

Financial Accounting Standards Board

The FASB Accounting Standards Codification® is the source of authoritative generally accepted accounting principles (GAAP) recognized by the FASB to be applied by nongovernmental entities. An Accounting Standards Update is not authoritative; rather, it is a document that communicates how the Accounting Standards Codification is being amended. It also provides other information to help a user of GAAP understand how and why GAAP is changing and when the changes will be effective.

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Financial Accounting Standards Board
801 Main Avenue ▪ Norwalk, CT ▪ 06851

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Summary

Why Is the FASB Issuing This Accounting Standards Update (Update)?

The FASB is issuing the amendments in this Update to improve generally accepted accounting principles (GAAP) by adding an illustrative example to demonstrate how an entity should apply the scope guidance in paragraph 718-10-15-3 to determine whether profits interest and similar awards ("profits interest awards") should be accounted for in accordance with Topic 718, Compensation—Stock Compensation.

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, stakeholders indicated that it can be complex 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). As a result, stakeholders highlighted existing diversity in practice.

Currently, entities evaluate the terms, conditions, and characteristics of a profits interest award and apply judgment to determine whether to account for the award under Topic 718 or Topic 710. However, stakeholders indicated that there is diversity in practice even when evaluating similar fact patterns. Therefore, stakeholders requested examples to clarify when the guidance in Topic 718 should be applied to profits interest awards (referred to herein as the "scope application issue"). Improving the Codification through the addition of scope application examples also will benefit investors and other allocators of capital by providing them with more consistent information.

The scope application issue, along with other related issues, was identified and discussed by the Private Company Council (PCC) because of the prevalence of profits interest awards among private companies. However, because the PCC research indicated that certain public business entities (PBEs) also may be required to account for profits interest awards, the PCC recommended that the Board add a project to address the scope application issue for PBEs and entities other than PBEs (that is, all reporting entities). The Board added that project, Scope Application of Profits Interest Awards: Compensation—Stock Compensation (Topic 718), to its technical agenda in December 2022.

This Update also amends certain language in the Scope and Scope Exceptions Section of Topic 718 to improve its clarity and operability without changing the guidance.

Who Is Affected by the Amendments in This Update?

The amendments in this Update related to the scope application issue apply to all reporting entities that account for profits interest awards as compensation to employees or nonemployees in return for goods or services.

The amendments in this Update that improve the understandability of paragraph 718-10-15-3 apply to all entities that enter into share-based payment transactions.

What Are the Main Provisions and Why Are They an Improvement to GAAP?

The amendments in this Update improve GAAP by adding an illustrative example that includes four fact patterns to demonstrate how an entity should apply the scope guidance in paragraph 718-10-15-3 to determine whether a profits interest award should be accounted for in accordance with Topic 718.

The fact patterns in the illustrative example focus on the scope conditions in paragraph 718-10-15-3. The illustrative example is intended to reduce (1) complexity in determining whether a profits interest award is subject to the guidance in Topic 718 and (2) existing diversity in practice.

The amendments in paragraph 718-10-15-3 improve its overall clarity and operability without changing the guidance.

When Will the Amendments Be Effective and What Are the Transition Requirements?

For PBEs, the amendments in this Update are effective for annual periods beginning after December 15, 2024, and interim periods within those annual periods. For all other entities, the amendments are 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. If an entity adopts the amendments in an interim period, it should adopt them as of the beginning of the annual period that includes that interim period.

The amendments in this Update should be applied either (1) retrospectively to all prior periods presented in the financial statements or (2) 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 amendments are applied retrospectively, an entity is required to provide the disclosures in paragraphs 250-10-50-1 through 50-3 in the period of adoption. If the amendments are applied prospectively, an entity is required to disclose the nature of and reason for the change in accounting principle.

Amendments to the *FASB Accounting Standards Codification*®

Introduction

1. The Accounting Standards Codification is amended as described in paragraphs 3–6. In some cases, to put the change in context, not only are the amended paragraphs shown but also the preceding and following paragraphs. Terms from the Master Glossary are in **bold** type. Added text is underlined, and deleted text is ~~struck out~~.

Master Glossary

2. The following Master Glossary terms are shown for context.

Issued, Issuance, or Issuing of an Equity Instrument

An equity instrument is issued when the issuing entity receives the agreed-upon consideration, which may be cash, an enforceable right to receive cash, or another financial instrument, goods, or services. An entity may conditionally transfer an equity instrument to another party under an arrangement that permits that party to choose at a later date or for a specified time whether to deliver the consideration or to forfeit the right to the conditionally transferred instrument with no further obligation. In that situation, the equity instrument is not issued until the issuing entity has received the consideration. The grant of stock options or other equity instruments subject to vesting conditions is not considered to be issuance.

Vest

To earn the rights to. A share-based payment award becomes vested at the date that the grantee's right to receive or retain shares, other instruments, or cash under the award is no longer contingent on satisfaction of either a service condition or a performance condition. Market conditions are not vesting conditions.

The stated vesting provisions of an award often establish the employee's requisite service period or the nonemployee's vesting period, and an award that has reached the end of the applicable period is vested. However, as indicated in the definition of requisite service period and equally applicable to a nonemployee's vesting period, the stated vesting period may differ from those periods in certain circumstances. Thus, the more precise terms would be options, shares, or awards for which the requisite good has been delivered or service has been rendered and the end of the employee's requisite service period or the nonemployee's vesting period.

Amendments to Subtopic 718-10

3. Amend paragraph 718-10-15-3 and add paragraph 718-10-15-3B, with a link to transition paragraph 718-10-65-17, as follows:

Compensation—Stock Compensation—Overall

Scope and Scope Exceptions

> Transactions

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:~~**issuing** (or offering to issue) its shares, share options, or other equity instruments or by~~ **[Content amended and moved to (a)]** ~~incurring liabilities to an **employee** or a nonemployee that meet either of the following conditions:~~ **[Content amended and moved to (b)]**

a. **Issuing** (or offering to issue) its shares, share options, or other equity instruments ~~or by~~to an **employee** or a nonemployee **[Content amended as shown and moved from paragraph 718-10-15-3]** ~~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**.)~~ **[Content moved to (b)(1)]**

b. <u>Incurring</u> liabilities to an **{remove glossary link}employee{remove glossary link}** or a nonemployee that meet either of the following conditions: **[Content amended as shown and moved from paragraph 718-10-15-3]** ~~The awards require or may require **settlement** by issuing the entity's equity shares or other equity instruments.~~ **[Content moved to (b)(2)]**
   <u>1.</u> 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**.) **[Content moved from (a)]**
   <u>2.</u> The awards require or may require **settlement** by issuing the entity's equity shares or other equity instruments. **[Content moved from (b)]**

[Note: The amendments to paragraph 718-10-15-3 improve its clarity and operability but do not change the guidance. The amended paragraph is shown below without markup for ease of readability.]

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.

718-10-15-3A Paragraphs 323-10-25-3 through 25-5 provide guidance on accounting for share-based compensation granted by an investor to employees or nonemployees of an equity method investee that provide goods or services to the investee that are used or consumed in the investee's operations.

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.

4. Add paragraphs 718-10-55-138 through 55-148 and their related headings, with a link to transition paragraph 718-10-65-17, as follows:

Implementation Guidance and Illustrations

> Illustrations

• > Example 10: Profits Interest and Similar Awards

718-10-55-138 This Example illustrates how an entity should apply the guidance in paragraph 718-10-15-3 to determine whether a profits interest or similar award is a share-based payment arrangement and is within the scope of this Topic or is not a share-based payment arrangement and, therefore, is within the scope of other Topics. The guidance in this Example is limited to the application of paragraph 718-10-15-3 and does not address how to apply other Sections of this Topic, including recognition, classification, initial measurement, subsequent measurement, other presentation matters, and disclosure.

718-10-55-139 Cases A, B, C, and D share the following assumptions:

a. Entity X is a partnership. Before June 1, 20X1, Entity X had Class A units outstanding. On June 1, 20X1, Entity X grants Class B incentive units to employees of a subsidiary of Entity X in exchange for services.
b. An exit event may include an initial public offering, a change in control, or a liquidation of Entity X's assets.

• • > Case A: Award Is a Share-Based Payment Arrangement

718-10-55-140 Additional assumptions are as follows:

a. The Class B units are profits interest units that are subordinated to the Class A units because after vesting they participate pro rata with the Class A units once the holders of the Class A units have received distributions equal to a predetermined distribution threshold established on the grant date of the Class B units.

b. The Class B units cliff vest at the end of three years of service.
c. Upon an exit event, the Class B units vest immediately if a grantee is still providing services to the subsidiary of Entity X. Upon such an event, the grantee would retain the vested Class B units, or if Class B units are settled through the exit event, Entity X would distribute proceeds to the Class B unit holders in the same manner as is described in (a).
d. If a grantee of the Class B units terminates employment with the subsidiary of Entity X (whether voluntarily, upon death, disability, or retirement or at the election of Entity X for reasons other than cause), any unvested Class B units will be forfeited for no consideration. If a grantee of the Class B units terminates employment after vesting, the grantee retains ownership of the vested Class B units, but upon the grantee's termination of employment, Entity X has a call right to repurchase the Class B units. If the call right is exercised, Entity X would pay the grantee of the Class B units an amount of cash equal to the fair value of the Class B units on the call date.

718-10-55-141 Entity X evaluates the conditions in paragraph 718-10-15-3 to determine whether to account for the Class B units by applying the guidance in this Topic. The Class B units meet the condition in paragraph 718-10-15-3(a) because both of the following indicate that Entity X is offering to issue shares or other equity instruments:

a. Either upon three years of service or an exit event, the grantor will have received the agreed-upon consideration (that is, the service will have been provided and the performance condition will have been met, if applicable) and the award will vest.
b. Holding the vested Class B units provides the grantee with the right to participate in the residual interest of Entity X through periodic distributions, upon an exit event, or upon settlement proportionate to ownership of Class B units of Entity X in accordance with the distribution waterfall described in paragraph 718-10-55-140(a).

Therefore, Entity X would account for the Class B units by applying the guidance in this Topic.

• • > Case B: Award Is a Share-Based Payment Arrangement

718-10-55-142 Additional assumptions are as follows:

a. The Class B units are profits interest units that are subordinated to the Class A units because once granted, they participate pro rata with the Class A units once the holders of the Class A units have received distributions equal to a predetermined distribution threshold established on the grant date of the Class B units.
b. The grantee of the Class B units is eligible to begin participating in nonforfeitable operating distributions at the grant date.
c. The Class B units only vest upon an exit event. Upon such an event, the grantee would retain the vested Class B units, or if Class B units are settled through the exit event, Entity X would distribute proceeds to the Class B unit holders in the same manner as is described in (a). Class B units are forfeitable upon the grantee's termination for any reason at any time before an exit event.

718-10-55-143 Entity X evaluates the conditions in paragraph 718-10-15-3 to determine whether to account for the Class B units by applying the guidance in this Topic. The Class B units meet the condition in paragraph 718-10-15-3(a) because both of the following indicate that Entity X is offering to issue shares or other equity instruments:

a. Upon an exit event, the grantor will have received the agreed-upon consideration (that is, the service will have been provided and the performance condition will have been met) and the award will vest.
b. Holding the vested Class B units provides the grantee with the right to participate in the residual interest of Entity X through periodic distributions, upon an exit event, or upon settlement proportionate to ownership of Class B units of Entity X in accordance with the distribution waterfall described in paragraph 718-10-55-142(a).

Therefore, Entity X would account for the Class B units by applying the guidance in this Topic.

718-10-55-144 The grantee of the Class B units is not entitled to retain the units if the grantee ceases to provide services before an exit event. Upon termination of employment before an exit event, the grantee of the Class B units would forfeit all rights to future distributions and would forfeit Class B units for no consideration. Entity X would account for the grantee's right to participate in nonforfeitable operating distributions in accordance with paragraph 718-10-55-45.

• • > Case C: Award Is a Share-Based Payment Arrangement

718-10-55-145 Additional assumptions are as follows:

a. The Class B units do not entitle the grantee to receive equity instruments of Entity X. This type of unit is often referred to as a phantom share unit.
b. The grantee of the Class B units is not eligible to participate in distributions in the ordinary course of business.
c. The grantee of the Class B units is eligible to receive cash upon an exit event. Upon an exit event, the Class B units vest immediately and must be settled in cash on the basis of the fair value of the Class B units. The fair value of the Class B units is calculated by reference to the price of Class A units of Entity X as determined at the date of the exit event.
d. The grantee of the Class B units must be providing services when the exit event occurs to receive any proceeds, and the Class B units are forfeitable upon the grantee's termination for any reason at any time before an exit event.

718-10-55-146 Entity X evaluates the conditions in paragraph 718-10-15-3 to determine whether to account for the Class B units by applying the guidance in this Topic. The Class B units do not meet the condition in paragraph 718-10-15-3(a) because they do not entitle the grantee to receive shares or other equity instruments of Entity X; therefore, Entity X is not issuing, or offering to issue, shares, share options, or other equity instruments. However, the condition in paragraph 718-10-15-3(b)(1) is met because the cash proceeds received by the grantee upon settlement in an exit event are based, at least in part, on the price of Entity X's shares. Therefore, Entity X would account for the Class B units by applying the guidance in this Topic.

• • > Case D: Award Is Not a Share-Based Payment Arrangement

718-10-55-147 Additional assumptions are as follows:

a. The Class B units do not entitle the grantee to receive equity instruments of Entity X. This type of unit is often referred to as a phantom share unit.
b. The grantee of the Class B units is eligible to participate in operating distributions made by Entity X equal to 1 percent of the preceding fiscal year's net income. The grantee of the Class B units is eligible to begin participating in these operating distributions after three years of service.

c. The grantee of the Class B units is not eligible to participate in any proceeds distributed upon an exit event.
d. The Class B units are forfeitable upon the grantee's termination for any reason at any time (including after the grantee has rendered three years of service).

718-10-55-148 Entity X evaluates the conditions in paragraph 718-10-15-3 to determine whether to account for the Class B units by applying the guidance in this Topic. The Class B units do not meet the condition in paragraph 718-10-15-3(a) because they do not entitle the grantee to receive shares or other equity instruments of Entity X; therefore, Entity X is not issuing or offering to issue shares, share options, or other equity instruments. In addition, the condition in paragraph 718-10-15-3(b)(1) is not met because the proceeds received by the grantee related to operating distributions are based on an operating metric (1 percent of the preceding fiscal year's net income) of Entity X and are not based, at least in part, on the price of Entity X's shares. Furthermore, the condition in paragraph 718-10-15-3(b)(2) is not met because there is no circumstance in which Entity X would be required to issue its equity shares or other equity instruments. Therefore, Entity X would not apply the guidance in this Topic to account for the Class B units and, instead, would account for the Class B units in accordance with other Topics.

5. Add paragraph 718-10-65-17 and its related heading as follows:

Transition and Open Effective Date Information

> Transition Related to Accounting Standards Update No. 2024-01, *Compensation—Stock Compensation (Topic 718): Scope Application of Profits Interest and Similar Awards*

718-10-65-17 The following represents the transition and effective date information related to Accounting Standards Update No. 2024-01, *Compensation—Stock Compensation (Topic 718): Scope Application of Profits Interest and Similar Awards:*

a. The pending content that links to this paragraph shall be effective for **public business entities** for annual periods beginning after December 15, 2024, and interim periods within those annual periods.
b. For entities other than public business entities, the pending content that links to this paragraph shall be effective for annual periods beginning

after December 15, 2025, and interim periods within those annual periods.

c. Early adoption of the pending content that links to this paragraph is permitted for both interim and annual financial statements that have not yet been issued or made available for issuance. If an entity adopts the pending content that links to this paragraph in an interim period, it shall adopt the pending content as of the beginning of the annual period that includes that interim period.

d. An entity shall apply the pending content that links to this paragraph either:
   1. Retrospectively to all prior periods presented in the financial statements in accordance with paragraphs 250-10-45-5 through 45-8. An entity that selects retrospective application shall provide the disclosures in paragraphs 250-10-50-1 through 50-3 in the period of adoption.
   2. Prospectively to profits interest or similar awards granted or modified on or after the date at which the entity first applies the pending content that links to this paragraph with disclosure that describes the nature of and reason for the change in accounting principle.

Amendments to Status Sections

6. Amend paragraph 718-10-00-1, by adding the following items to the table, as follows:

718-10-00-1 The following table identifies the changes made to this Subtopic.

Paragraph	Action	Accounting Standards Update	Date
718-10-15-3	Amended	2024-01	03/21/2024
718-10-15-3B	Added	2024-01	03/21/2024
718-10-55-138 through 55-148	Added	2024-01	03/21/2024
718-10-65-17	Added	2024-01	03/21/2024

The amendments in this Update were adopted by the unanimous vote of the seven members of the Financial Accounting Standards Board:

Richard R. Jones, *Chair*
James L. Kroeker, *Vice Chairman*
Christine A. Botosan
Frederick L. Cannon
Susan M. Cosper
Marsha L. Hunt
Dr. Joyce T. Joseph

Background Information and Basis for Conclusions

Introduction

BC1. The following summarizes the Board's considerations in reaching the conclusions in this Update. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

Background Information

BC2. 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. Profits interest awards also may incentivize recipients to assist the entity to achieve a specific operating metric or objective. In October 2018, the FASB received an agenda request that asked the Board to provide specific guidance about whether a profits interest award should be accounted for as a share-based payment arrangement under Topic 718 or similar to a cash bonus or profit-sharing arrangement under Topic 710 or other Topics. The agenda request described a "facts and circumstances based approach" that many entities have applied in practice to determine whether a profits interest award is within the scope of Topic 718 or another Topic. The agenda request indicated that the application of this approach has resulted in diversity in practice and inconsistent conclusions regarding similar fact patterns.

BC3. *Profits interest* is not a defined term in the Master Glossary of the Codification. *Profits interest* is defined in IRS Revenue Procedure (Rev. Proc.) 93-27 as a "partnership interest other than a capital interest." Under Rev. Proc. 93-27, a profits interest is 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. Typically, legal form profits interests are issued by LLCs and limited partnerships (LPs) but may be issued by other types of partnerships.

BC4. While the term *profits interest* is not defined in the Master Glossary, Topic 718 indicates that partnership interests could be included within its scope. The term *share-based payment arrangements* is defined in the Master Glossary and states, in part:

> The term shares includes various forms of ownership interest that may not take the legal form of securities (for example, partnership interests), as well as other interests, including those that are liabilities in substance but not in form.

BC5. The characteristics of profits interest awards can vary such that in practice entities have concluded that some awards are more akin to other types of equity awards (such as stock options), while other awards are 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.
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 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, recapitalization, IPO, or other 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 the recipient for beneficial tax treatment.

BC6. When discussing the scope application issue, stakeholders indicated that the existing diversity in practice applies to both (a) awards that meet the legal definition of a profits interest and (b) other types of awards. There are other types of awards that are economically similar to profits interest awards but that do not meet the legal definition of a profits interest. Examples include share appreciation rights or phantom share units granted by a partnership that convey rights that are similar to those of a profits interest award but that do not convey legal equity. Such awards are common in grants to international employees and nonemployees.

BC7. In response to the 2018 agenda request, in August 2020 the PCC formed a working group to conduct outreach to determine whether there were pervasive practice-related issues that should be addressed. To assist the working group, the FASB staff performed additional research and outreach on issues related to profits interest awards, including various discussions with the PCC.

BC8. At the April 2022 PCC meeting, the FASB staff presented an analysis and recommendations on the scope application issue to assist the PCC's Technical Agenda Consultation Group when discussing whether to recommend that the PCC or the Board add a project to its technical agenda. Through research and outreach conducted with the assistance of the PCC working group, the PCC determined that the largest population of operating companies with profits interest awards is private equity portfolio companies; however, profits interest awards also can be issued by other types of private companies. The PCC also determined that the scope application issue is not solely limited to private companies because certain PBEs also may be required to account for profits interest awards that remain outstanding when (a) the entity has not yet completed an IPO but has 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. Because the scope application issue is not limited to private companies, the PCC recommended that the Board add a project to its technical agenda. Given the prevalence of profits interest awards in private company compensation plans, the PCC also provided input for the

Board's consideration about a potential illustrative example and transition guidance.

BC9. In December 2022, the Board added a project in response to the PCC's recommendation to improve GAAP by developing an example to illustrate how an entity would apply the scope guidance in paragraph 718-10-15-3 to determine whether a profits interest award should be accounted for in accordance with Topic 718. Given the existing diversity in practice, the Board expects that the clarifications from the amendments in this Update may result in more profits interest awards being accounted for in accordance with Topic 718.

BC10. On May 11, 2023, the Board issued proposed Accounting Standards Update, *Compensation—Stock Compensation (Topic 718): Scope Application of Profits Interest Awards*, for public comment with the comment period ending on July 10, 2023. The Board received 21 comment letters in response to the proposed Update. Nearly all respondents expressed general support for the amendments in the proposed Update and agreed that the cases included in the proposed illustrative example were clear and operable and would provide clarity on whether profits interest awards should be accounted for under Topic 718. While those respondents expressed overall support, they also provided suggestions on various areas for further improvement or clarification, as discussed in paragraphs BC16–BC25.

BC11. PCC members supported the amendments in the proposed Update and noted that the proposed illustrative example would help to reduce diversity in practice. PCC members also supported the proposed transition requirements and emphasized the importance of communicating the final amendments to relevant stakeholders.

Benefits and Costs

BC12. The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, donors, and other capital market participants in making rational investment, credit, and resource allocation decisions. However, the benefits of providing information for that purpose should justify the related costs. Present and potential investors, creditors, donors, and other users of financial information benefit from improvements in financial reporting, while the costs to implement new guidance are borne primarily by present investors. The Board's assessment of the costs and benefits of issuing new guidance is unavoidably more qualitative than quantitative because there is no method to objectively measure the costs to implement new guidance or to quantify the value of improved information in financial statements.

BC13. Overall, the Board concluded that the expected benefits of the amendments in this Update justify the expected costs for all reporting entities. The example illustrates the application of paragraph 718-10-15-3 to profits interest and similar awards with different terms and characteristics and is intended to reduce (a) complexity in determining whether a profits interest or similar award is subject to the guidance in Topic 718 and (b) diversity in practice. Investors and other allocators of capital will benefit from entities accounting for economically similar awards consistently.

BC14. The Board expects the amendments in this Update to improve GAAP by adding an illustrative example to demonstrate how an entity should apply the scope guidance in paragraph 718-10-15-3 to determine whether profits interest and similar awards should be accounted for in accordance with Topic 718. The Board acknowledged that some preparers that currently are accounting for certain profits interest and similar awards under Topic 710 or other Topics may conclude on the basis of the illustrative example that those awards should be accounted for under Topic 718. Those preparers may incur incremental costs to apply the guidance in Topic 718. However, the Board expects that the primary benefit of the amendments is that they will result in an overall cost reduction for entities that have awards with common fact patterns that are similar to those illustrated in the example.

Basis for Conclusions

Scope

BC15. The amendments in this Update related to the scope application issue apply to all reporting entities that account for profits interest awards as compensation to employees or nonemployees in return for goods or services (including PBEs and entities other than PBEs).

BC16. As discussed in paragraphs BC3–BC6, given the variability in legal form, terms, and characteristics of profits interest awards, in initial deliberations the

Board decided not to define the term *profits interest* in the Codification. Rather, the amendments in the proposed Update referred to both profits interest and similar awards. Some comment letter respondents requested that the Board clarify (a) the definition of *profits interest awards* or (b) whether the legal form of an award would determine the scope of the guidance to apply. During redeliberations, the Board considered but decided not to clarify either of those points because of potential unintended consequences, such as suggesting that the scope of guidance applied to an award should be based solely or predominantly on its legal form rather than on a complete evaluation of all information. The Board affirmed its decision that the amendments in this Update apply to profits interest and similar awards. In addition, on the basis of comment letter feedback, the Board clarified that the amendments apply to profits interest and similar awards issued to both employees and nonemployees as compensation in exchange for goods or services.

BC17. The amendments in this Update that improve the understandability of paragraph 718-10-15-3 apply to all entities that enter into share-based payment transactions.

Illustrative Example

BC18. The illustrative example included in the amendments in this Update is intended to demonstrate how an entity would apply the scope guidance in paragraph 718-10-15-3 to determine whether a profits interest award should be accounted for in accordance with Topic 718.

BC19. Paragraph 718-10-15-3 includes conditions that determine whether an award should be accounted for in accordance with Topic 718. Those conditions include 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.

BC20. The approach generally applied in practice today (discussed in paragraph BC2) to determine whether a profits interest award should be accounted for under Topic 718 or another Topic has led to diversity in practice. The illustrative example is intended to highlight common fact patterns and emphasize relevant facts to be evaluated when determining whether a profits interest award meets the scope guidance in paragraph 718-10-15-3. The illustrative example does not address how to apply other guidance in Topic 718, including whether a profits interest award should be classified as a liability or as equity.

BC21. The illustrative example in the proposed Update included four cases that had different fact patterns and highlighted key considerations to help an entity determine how to evaluate common terms and characteristics of profits interest awards that were identified as part of research and outreach. Comment letter respondents expressed general support for the amendments in the proposed Update and agreed that the cases included in the proposed illustrative example would improve clarity of the scope application issue. However, some comment letter respondents observed that the proposed cases primarily focused on the conditions in paragraph 718-10-15-3(b)(1) through (b)(2), that is, awards in which an entity has incurred a liability. Those respondents requested that the Board clarify how an entity would determine whether, in a profits interest award, the entity is "issuing (or offering to issue) its shares, share options, or other equity instruments" in accordance with paragraph 718-10-15-3(a) and, therefore, whether that award is within the scope of Topic 718. Some respondents stated that the fact patterns described in proposed Case A and Case B would meet the condition in paragraph 718-10-15-3(a).

BC22. On the basis of feedback received, the Board decided to revise Case A and Case B of the example to illustrate awards that meet the condition in paragraph 718-10-15-3(a). The conclusions in Case A and Case B are consistent with the principles originally established by FASB Statement No. 123 (revised 2004), *Share-Based Payment* (now included in Topic 718). Topic 718 requires that an entity recognize the cost of employee (and nonemployee) services (and goods) received in exchange for awards of equity instruments based on the fair value of those awards, with limited exceptions. The Board also decided to clarify in Cases A and B how an entity should consider a grantee's right to participate in periodic distributions when applying paragraph 718-10-15-3.

BC23. Also on the basis of feedback received, the Board decided to revise Case C in the illustrative example to include a fact pattern in which the Class B units do not entitle the grantee to receive equity instruments and are required to be settled in cash upon an exit event. This type of unit is often referred to as a phantom share unit. The settlement amount is based on the fair value of the Class B units as determined by reference to the price of Class A units at the date of the exit event; therefore, Case C concludes that the award meets the condition in paragraph 718-10-15-3(b)(1) because the proceeds that would be received by the grantee upon settlement in an exit event are based, at least in part, on the price of the entity's shares. The revisions to Case C benefit stakeholders because the illustrative example now addresses all aspects of paragraph 718-10-15-3, including scenarios in which (a) an entity issues or offers to issue equity and (b) an entity incurs a liability that is either (1) partially or fully based on the entity's equity or (2) settled in shares or other equity. In addition, Case D illustrates an award that is not within the scope of Topic 718.

BC24. Some comment letter respondents requested that the Board revise the illustrative example to demonstrate how an entity would consider additional award features in determining the appropriate scope of guidance to apply. Examples cited by respondents included a below-market call feature and an award linked to earnings before interest, taxes, depreciation, and amortization (EBITDA) targets. The Board considered but decided not to incorporate additional award features in the illustrative example because including those features may have unintended consequences, such as suggesting that a certain feature by itself is determinative.

BC25. Some comment letter respondents requested that the Board clarify or provide additional guidance on the recognition, measurement, classification, or presentation of profits interest awards that are accounted for within the scope of Topic 718. The Board decided not to address those issues because the scope of the project was intended to address only the application of the scope guidance in Topic 718.

BC26. The illustrative example in the amendments in this Update demonstrates how an entity might apply paragraph 718-10-15-3 to a profits interest or similar award on the basis of the limited facts presented. However, the illustrative example is not intended to be all-inclusive. Entities should consider all relevant information and apply judgment when determining whether a profits interest or similar award should be accounted for in accordance with Topic 718.

Codification Improvements

BC27. Some stakeholders observed that the structure of paragraph 718-10-15-3, as written in the Codification, was confusing and difficult to apply. As a result, the Board amended paragraph 718-10-15-3 to (a) improve overall clarity and operability and (b) more clearly articulate how the conclusions reached in the illustrative example in paragraphs 718-10-55-138 through 55-148 correlate to specific conditions in paragraph 718-10-15-3. The amendments to paragraph 718-10-15-3 in this Update are editorial in nature and relate solely to the application of the scope guidance in Topic 718. The changes do not affect an entity's application of the guidance in Topic 718 when determining whether an award should be classified as a liability or as equity.

Effective Date and Transition

BC28. The Board decided that for PBEs, the amendments are effective for annual periods beginning after December 15, 2024, and interim periods within those annual periods. For entities other than PBEs, the amendments are effective for annual periods beginning after December 15, 2025, and interim periods within those annual periods.

BC29. The Board decided to permit early adoption for both interim and annual financial statements that have not yet been issued or made available for issuance. If an entity adopts the amendments in this Update in an interim period, it must adopt them as of the beginning of the annual period that includes that interim period. The Board observed that early adoption allows all entities to evaluate their specific circumstances and select the most appropriate adoption date. The Board also noted that early adoption could lead to more timely improvement in the consistency of application of the guidance.

BC30. The Board decided to require that an entity apply the amendments in this Update either (a) retrospectively to all prior periods presented in the financial statements or (b) prospectively to profits interest or similar awards granted or modified on or after the date at which the entity first applies the amendments. If the amendments are applied retrospectively, an entity is required to provide the disclosures in paragraphs 250-10-50-1 through 50-3 in the period of adoption. If the amendments are applied prospectively, an entity is required to disclose the nature of and reason for the change in accounting principle.

BC31. During initial deliberations, the Board considered whether to require retrospective application, noting that this approach may be costly because an entity applying the amendments in this Update retrospectively might incur costs to acquire certain information required by Topic 718 (such as the grant date fair value for equity-classified awards or the determination of whether modifications were made after an award's grant date). In addition, the Board considered that some entities may prefer to apply the amendments retrospectively so that similar awards are accounted for consistently going forward. Therefore, the Board decided to permit either retrospective application or prospective application. Comment letter respondents agreed with this transition approach, and the Board affirmed its decision to permit either retrospective application or prospective application.

Amendments to the GAAP Taxonomy

The amendments to the *FASB Accounting Standards Codification*® in this Accounting Standards Update require improvements to the GAAP Financial Reporting Taxonomy and SEC Reporting Taxonomy (collectively referred to as the "GAAP Taxonomy"). Those improvements, which will be incorporated into the proposed 2025 GAAP Taxonomy, are available through GAAP Taxonomy Improvements provided at www.fasb.org, and finalized as part of the annual release process.