FINANCIAL ACCOUNTING STANDARDS BOARD

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| | Memo No. | **4** |
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| Project | **Profits Interests and Their Interrelationship with Partnership Accounting** |
| Project Stage | **Research** |
| Issues | **Research Summary—Scope of Guidance for Profits Interest Awards** |

## Memo Purpose

1. The purpose of this memo is to provide a summary of research, including outreach, on the accounting issue of determining the appropriate scope of guidance applicable to profits interests.

2. During the first quarter of 2022, the PCC Technical Agenda Consultation Group is expected to meet to discuss the merits of a potential project on the scope of guidance applicable to profits interests.

3. During the April 2022 PCC meeting, the PCC is expected to decide whether to (a) add a project to its technical agenda, (b) recommend that the Board add a project addressing this issue to its own technical agenda, or (c) decline to add a project on this issue.

4. This memo will be used for discussions with the PCC Technical Agenda Consultation Group and the PCC. A separate, forthcoming memo will include an analysis of the agenda decision criteria.

5. This memo is organized as follows:

    (a) Issue Background:

        (1) Overview of PCC Research

        (2) Overview of Profits Interests

        (3) Summary of Agenda Request

    (b) Staff Research:

        (1) Authoritative Guidance

        (2) Nonauthoritative Guidance

(3) Prevalence in Public Business Entities

(c) Summary of Outreach

(1) Types of Entities That Grant Profits Interests

(2) Diversity in Practice

(3) Implications for Partnership Accounting Practices

(4) Need for Standard Setting

(5) Potential Solutions

(d) Next Steps

(e) Appendix A: BDO Agenda Request Letter

| **Questions for the PCC** |
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| 1. Do PCC members have any questions about the agenda request?<br><br>2. Do PCC members have any questions on the summary of the authoritative guidance in Topic 718—Compensation—Stock Compensation?<br><br>3. Do PCC members have any questions on the summary of the SEC speech or the guidance in practitioner publications?<br><br>4. Do PCC members have any questions on the summary of the research on the prevalence of profits interests in public business entities?<br><br>5. Do PCC members have any questions on the summary of outreach?<br><br>6. What additional information, if any, would you need to decide on a potential standard-setting project at a future PCC meeting? |

## Issue Background

6. *Please note: Paragraphs 7 through 18 briefly summarize prior staff and Working Group research on profits interests while paragraph 19 through the end of this memo contains new research.*

### Overview of PCC Research

7. During the June 8, 2020 Private Company Council (PCC) Education Session and the June 25, 2020 PCC meeting, the staff presented educational materials to the PCC on profits interests and their

interrelationship with partnership accounting. During the latter meeting, PCC and Board members provided feedback to the staff and posed additional questions on profits interests and partnership accounting. The educational materials were contained in PCC Memo 1, *Private Company Pre-Agenda Research*.

8. In August 2020, the PCC formed a working group (hereinafter, the Working Group) to assist the staff with outreach and identify related practice issues. Following a meeting with the Working Group, the staff performed additional research, including outreach, on taxation and valuation issues related to profits interests.

9. During the April 20, 2021 PCC meeting, the staff summarized its research and the feedback that it and the Working Group received from taxation and valuation specialists on profits interests and noted that additional research and outreach would be conducted to better understand accounting issues about profits interests. The summary of the staff's research is included in PCC Memo 2, *Research and Outreach Summary*.

10. During the June 22, 2021 PCC meeting, the staff presented an example of profits interests granted by a private company that remained outstanding after an initial public offering (IPO) (see this link for presentation). Also, during that PCC meeting, PCC members provided feedback about their experiences with profits interest awards. PCC members explained that the terms of profits interest awards can be complex and vary across companies and noted that determining the appropriate scope of guidance and measuring profits interest awards in the scope of Topic 718, Compensation—Stock Compensation, can be challenging. Furthermore, PCC members stressed the importance of broadly considering the types of partnerships and similar entities that issue profits interests for the purposes of scoping a potential project.

11. During the September 27, 2021 PCC meeting, the staff provided an interim update on feedback received during outreach conducted since the June 2021 PCC meeting. See PCC Memo 3, *Outreach Update*.

## Overview of Profits Interests

### *What Is a Profits Interest?*

12. As discussed in PCC Memo 1 and PCC Memo 2, profits interests are not defined in the Master Glossary of the Codification and are, instead, defined for federal income tax purposes under Revenue Procedure 93-27 (Rev. Proc. 93-27).[1] Under Rev. Proc. 93-27, a profits interest is an interest in a partnership that

[1] Revenue Procedure 93-27 defines a capital interest as an interest that would give the holder a share of 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. That determination generally is made at the time of receipt of the partnership interest. Revenue Procedure 93-27 defines a profits interest as a partnership interest other than a capital interest.

would receive no proceeds if the partnership were immediately liquidated. Profits interests can only be granted by entities taxed as partnerships and, therefore, cannot be granted by legal entities taxed as corporations.

13. Profits interests are contrasted with *capital interests*, which are partnership interests whose holders *would* receive proceeds if the entity were immediately liquidated.

14. A profits interest provides the holder with rights to a share of only the partnership's *future profits and/or equity appreciation*. By contrast, a profits interest does not provide the holder with rights to the existing net assets of the partnership. Rights to existing net assets of the partnership are *capital interests*.

15. The following is a simplified example of a profits interest (reproduced from PCC Memo 2).

**Example of a profits interest:**

At 1/1/20X0 Company LLC initially has one class of equity (Class A units).

Company LLC's balance sheet (on a fair value basis) as of 2/1/20X0 (one month later) is included in the chart below.

| | | | |
|---|---|---|---|
| Assets | $ | 3,000,000 | Fair market value |
| Liabilities | $ | (1,000,000) | |
| Equity | $ | (2,000,000) | Class A |

On 2/1/20X0, in exchange for services provided by the CEO of Corporation X, a wholly owned subsidiary of Company LLC, Company LLC creates a new class of equity (Class B units) and grants those Class B equity units to the CEO of Corporation X. The units will vest (will be issued to the CEO of Corporation X) contingent upon the CEO remaining an employee of Corporation X for the next 4 years. If the CEO of Corporation X resigns or is terminated for any reason before completing 4 years of service, the Class B units are forfeited in their entirety. The Class B units vest immediately upon a change in control.

The operating agreement for Company LLC is amended and states that the Class B units receive 20% of sale or liquidation proceeds in excess of $5 million. Because the Class B equity units would not receive any proceeds in a hypothetical liquidation upon grant on 2/1/20X0 (as stated above, Company LLC's net assets have a fair market value of only $2 million), the *Class B units are profits interests*. Under the terms of the operating agreement for Company LLC, the Class B units do not provide the holder with any voting or participating rights. The Class B units are not transferable and are subject to drag along rights (the Class B unit holders cannot refuse to sell their interests if the Class A unit holders sell their interests in a transaction, even if this results in the Class B unit holders receiving few or no proceeds because the total purchase price is less than $5 million).

The recipient of the Class B units benefits only if the fair value of the company's equity appreciates above $5 million and the Class A unit holders complete a sale or liquidate the business. For example, if in 5 years the CEO vested in the units and all of the equity interests in Company LLC are sold for $9 million, then the proceeds would be distributed as follows.

| | | | |
|---|---|---|---|
| Total Proceeds | $ | 9,000,000 | Description |
| Due to Class A | $ | 8,200,000 | $5 million + 80% of $4 million |
| Due to Class B | $ | 800,000 | 20% of $4 million |

Unlike the Class B units, at 2/1/20X0 the Class A units would represent a capital interest because the holders of the Class A units would have received proceeds if Company LLC had been immediately liquidated at grant (2/1/20X0) for $2 million.

***Federal Taxation of Profits Interests***

16. Profits interests carry tax advantages from the perspective of the grantee when compared to other forms of equity compensation issuable by both partnerships and corporations. Unlike awards of capital interests, profits interests are assumed to have no fair market value at the grant date or vesting date for tax purposes and they can be taxed at favorable capital gains rates, rather than ordinary income rates, when settled.

17. Rev. Proc. 93-27, which establishes the taxation of profits interests issued for services rendered or for the benefit of the partnership, does not apply in any of the following circumstances:

    (a) If the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease

    (b) If within two years of receipt, the partner disposes of the profits interest

    (c) If the profits interest is a limited partnership interest in a *publicly traded partnership* within the meaning of Section 7704(b) of the Internal Revenue Code.

18. From the perspective of the grantee, profits interests confer tax benefits not available to recipients of economically similar equity incentives, such as nonqualified stock options.

**Summary of Agenda Request**

19. The Board received an agenda request from BDO in October 2018 (see Appendix A) to address whether certain equity interests in a partnership and similar legal structures are subject to the guidance in Topic 710, Compensation—General, or Topic 718.

***Background on Profits Interests and Similar Interests***

20. The agenda request asserts that the characteristics of profits interests "vary, such that they may be, in substance, akin to a performance bonus or a profit-sharing arrangement," rather than akin to a share-based payment award. The agenda request also lists the following as other common characteristics of profits interests:

    (a) Management's intent is to award the recipient substantial compensation upon a sale, liquidity event (for example, initial public offering or other change of control), or final liquidation of the entity.

    (b) Profits interests have a relatively high distribution hurdle. Recipients of such profits interests generally will not receive partnership distributions in the normal course of business due to the

high threshold of distribution required, and the level of subordination. Recipients are more likely to receive residual value upon a sale or liquidity event.

(c) Profits interests frequently have an explicit performance condition linked to a change in control, recapitalization, initial public offering, or other liquidity event.

(d) Profits interests may or may not have an explicit service condition required for vesting.

(e) Forfeiture provisions vary—some awards are forfeited upon separation from the company for any reason. Other awards include a call option at fair market value, calculated value, or some other amount.

***Scope Issues and Diversity in Practice***

21. According to the agenda request, the issue is whether profits interests and similar interests are subject to Topic 710 or to Topic 718. That is, whether, for accounting purposes, profits interests should be accounted for as share-based payments (Topic 718) or whether they should be accounted for similarly to cash bonuses and profit-sharing arrangements (Topic 710).

22. The agenda request states that a "facts-and-circumstances-based" approach has resulted in diversity in practice in how entities determine whether Topic 710 or Topic 718 is the appropriate scope of guidance for profits interest awards. The agenda request notes that under this approach "[s]imilar awards with similar features may be accounted for differently."

*Differences Between Topic 710 and Topic 718*

23. The guidance in Topic 710 (deferred compensation arrangements) and the guidance in Topic 718 (share-based payments) vary significantly in terms of specificity and prescriptiveness. The guidance in Topic 718 is relatively specific and prescriptive, and consequently, more complex. By contrast, the guidance for deferred compensation arrangements within Topic 710 is brief and sets forth broad guidance for measurement and recognition. Moreover, there are no disclosure requirements specific to deferred compensation arrangements in Section 710-10-50, Compensation—General—Overall—Overall—Disclosure.

24. Profits interests accounted for as deferred compensation arrangements under Topic 710 are accounted for as liabilities. A deferred compensation arrangement within the scope of Topic 710 is measured at the present value of all future benefits expected to be paid and is accrued over the period of an employee's service in a systematic and rational manner. When applying Topic 710, the agenda request suggests that compensation cost should not be recognized until payment is probable and reasonably estimable.[2] The "probable and reasonably estimable" threshold is the same threshold used in Topic

[2] The terms *probable* and *reasonably estimable* are not included in paragraphs 710-10-25-9 through 25-11 on recognition or paragraphs 710-10-30-1 through 30-2 on initial measurement.

450, Contingencies, for recording contingent liabilities and is described in Topic 710, for the accrual of compensated absences.

25. Profits interests accounted for within the scope of Topic 718 are either equity-classified or liability-classified according to the guidance within that Topic. In contrast to the guidance for deferred compensation in Topic 710, the guidance for share-based payments in Topic 718 also provides more specific guidance for measurement and recognition, including guidance on vesting conditions that are common in grants of profits interests. For example, the Master Glossary definition of *performance conditions* explicitly includes performance targets, IPOs, and changes in control.

26. A summary of the key differences in accounting for awards under Topic 710 and Topic 718 is included below.

| | **Deferred Compensation Arrangements Topic 710** | **Share-Based Payments Topic 718** |
|---|---|---|
| Classification | Liabilities | Equity or liabilities based on assessment of Topic 718 framework |
| Measurement | Present value of the benefits expected to be provided to the employee | Equity: Grant-date fair value (or calculated value)<br>Liabilities: Remeasured at fair value or intrinsic value each period |
| Recognition | The portion applicable to the current services is accrued each period (agenda request suggests 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) |

27. In addition to the differences described in the table above, the agenda request also notes that the "presentation of subsequent distributions to instrument holders" differs under the two sets of guidance as follows:

> Under Topic 710, cash distributions to instrument holders represent compensation cost, while under Topic 718, distributions to holders of vested awards are treated as capital transactions (e.g., dividends) and generally do not result in additional compensation cost (absent a modification or settlement).

*2006 U.S. Securities and Exchange Commission (SEC) Speech*

28. The agenda request notes that in December 2006 a Professional Accounting Fellow in the SEC's Office of the Chief Accountant addressed scoping issues related to special classes of stock granted to employees (hereinafter, the "SEC speech").[3] The SEC speech does not address profits interests by

[3] https://www.sec.gov/news/speech/2006/spch121106jbu.htm

name but describes instruments that are similar in substance. The agenda request excerpted the following passage from the speech:

> Several accounting issues arise when a special class of stock is granted to employees. First and foremost, one must look through the legal form of the instrument to determine whether the instrument is in fact a substantive class of equity for accounting purposes, or is instead similar to a performance bonus or profit sharing arrangement. When making this determination, all relevant features of the special class must be considered. There are no bright lines or litmus tests. When few if any assets underlie the special class, or the holder's claim to those assets is heavily subordinated, the arrangement often has characteristics of a performance bonus or profit-sharing arrangement. Instruments that provide the holder with substantive voting rights and pari passu dividend rights are at times indicative of an equity interest. Consideration should also be given to any investment required, and any put and call rights that may limit the employee's downside risk or provide for cash settlement. Many of these factors were contained in Issues 28 and 40 of EITF Issue 00-23, which provided guidance on the accounting under Opinion 25 for certain of these arrangements.
>
> When the substance of the instrument is that of a performance bonus or profit sharing arrangement, it should be accounted for as such. In those circumstances, any returns to the employee should be reflected as compensation expense, not as equity distributions or minority interest expense. Further, if the employee remitted consideration at the outset of the arrangement in exchange for the instrument, such consideration should generally be reflected in the balance sheet as a deposit liability. [Footnotes omitted.]

29. Although the SEC speech acknowledged the guidance that, at the time, had been recently issued in FASB Statement No. 123 (revised 2004), *Share-Based Payment* (codified as Topic 718), it stated that it drew factors from the superseded guidance in EITF Issue No. 00-23, "Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44."

30. The staff notes that although Statement 123R had been issued before the SEC speech, the SEC speech did not directly address how the factors it cited interacted with the scope guidance in Statement 123R. Instead, the term *substantive class of equity* relates to the superseded guidance in EITF Issue 00-23.[4]

[4] Whether tracking stock was "substantive" is discussed in Issue 28(a), *Whether Opinion 25 applies to the accounting by a subsidiary (in that subsidiary's separate GAAP financial statements) for stock compensation granted to its employees based on tracking stock that is referenced to either that subsidiary or another subsidiary in the consolidated group*.

> **125**. If a tracking stock is not substantive, the Task Force concluded that while the stock may be legal equity of the parent, it is not equity for accounting purposes under Opinion 25 of either the parent or the subsidiary to which it tracks. In that case, the award should be accounted for as a cash-based or formula arrangement in both the separate financial statements of the subsidiary whose employees receive the award and in the consolidated financial statements.
>
> **126**. In determining whether a tracking stock is substantive, the Task Force noted that an entity should consider the reason(s) for issuance, whether the shares have been issued to substantive third parties, and the voting rights of those shareholders in comparison to the rights of holders of the parent company stock. The Task Force also observed that a tracking stock is substantive if it is publicly traded.

*Diversity in practice*

31. The agenda request described the approach that many have implemented in practice as a "facts and circumstances" approach and noted that it results in diversity in practice. The agenda request also describes how entities may be applying the facts and circumstances approach.

32. The agenda request stated that under the facts and circumstances approach the following factors indicate that an award is like a profit-sharing arrangement or performance bonus and, therefore, within the scope of Topic 710; some of the factors referenced were discussed in the SEC speech:

    (a) Few, if any, assets underlie the special class of units (or the class of units is heavily subordinated)

    (b) The rights embodied in the special class of units are not like the entity's other equity interests (for example, lack of voting rights, lack of transferability, and/or lack of preemptive rights)

    (c) Special class of units contains explicit or implicit cash-settlement features. Identifying implicit cash-settlement features may require an understanding of management's intent.

    (d) No initial investment required.

33. The agenda request also noted that under the "facts and circumstances" approach the following factors indicate that an award is within the scope of Topic 718:

    (a) Legal form of the security is equity

    (b) Distributions are at the discretion of the company and not legally contingent upon a liquidity event (such as a change in control or IPO)

    (c) Recipients are treated as partners for tax purposes[5]

    (d) Payment under the award is based, at least in part, on the price of the company's shares or other equity instruments

    (e) The units may be replaced with other equity interests in a change in control

    (f) A company has a separate cash bonus program.

*Recommended Solution*

34. To reduce the diversity in practice noted above, BDO's agenda request recommended the solution below that would amend the scope exception in Topic 710.

> In order to reduce diversity in practice, and in the spirit of the FASB's goal of improving the usefulness of the information provided to the users of financial statements while reducing cost and complexity in financial reporting through the Simplification Initiative, we recommend that Section 710-10-15 be clarified to specify that all awards issued based on

[5] As noted in PCC Memo 2, the recipient of a profits interests is always considered a partner of the partnership that grants the profits interests for tax purposes.

the underlying legal equity of the employer are excluded from the scope of ASC 710. For instance, paragraph 710-10-15-5(e) might be modified to state the following:

> *Stock compensation plans that are addressed by Topic 718, including awards such as profits interests that require or may require settlement by issuing the entity's equity shares or other equity instruments, or the amounts are based, at least in part, on the price of the entity's shares or other equity instruments.*

In this context, we see no reason why Topic 718 may not be applied to all profits interests.

*Outcomes in Practice*

35. Appendix B of BDO's agenda request provides two illustrative examples that demonstrate how the list of factors (see paragraphs 32 and 33) it describes would be applied under the facts and circumstances approach. BDO points out that both examples contain a mix of factors, some that point to Topic 710 and others that point to Topic 718.

## Staff Research

### Authoritative Guidance

#### *Topic 718*

36. The term *profits interests* is not defined in the Codification and there is currently no authoritative guidance *specific to profits interests* for determining whether they should be accounted for in accordance with Topic 718 or Topic 710.

37. Paragraph 718-10-15-3 states that the stock compensation guidance in Topic 718 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 by issuing (or offering to issue) its shares, share options, or other equity instruments or by incurring liabilities to an employee or 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 share and something else that is neither the price of the entity's share nor a market, performance, or service condition).

    (b) The awards require or may require settlement by issuing the entity's equity shares or other equity instruments.

38. Additionally, the Master Glossary definition in the Codification of *share-based payment arrangements* indicates that the term *shares* includes various forms of ownership interests that may not take the legal form of securities ("partnership interests" are provided as an example), as well as other interests, including those that are liabilities in substance but not in form.

39. Certain instruments that can be economically similar to profits interests, such as stock appreciation rights, represent share-based payment arrangements when granted for goods or services and are typically accounted for within the scope of Topic 718. This would apply even when such instruments are required to be cash-settled because the amount of the cash payment is indexed to the price of the entity's equity shares, consistent with the guidance in paragraph 718-10-15-3.

***Topic 710***

40. If an entity determines that its profits interest arrangement is not within the scope of Topic 718, it may be a deferred compensation arrangement within the scope of Topic 710. Subparagraph 710-10-15-4(c) broadly states that "other deferred compensation contracts accounted for individually" are within the scope of Topic 710, while paragraph 710-10-15-5(e) scopes out stock compensation plans that are addressed by Topic 718.

> **710-10-15-5** The guidance in this Topic does not apply to the following deferred compensation or employee benefit arrangements:
>
> e. Stock compensation plans that are addressed by Topic 718

***Partnership Accounting***

41. There is no relevant guidance in the Codification that discusses specialized partnership accounting practices applicable to operating companies. As noted above, the Master Glossary definition of share-based payment arrangements states that:

> 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.

42. However, nonauthoritative guidance reviewed by the staff acknowledges that questions sometimes arise as to whether an interest in a limited liability entity is (a) a form of compensation to an employee or (b) a distribution to a partner in their capacity as an owner.

43. The staff understands that under a partnership accounting model, the grant of a partnership interest in exchange for services would not be subject to the guidance in either Topic 710 or Topic 718. Instead, when distributions are eventually paid to a partner in their capacity as an owner, the reporting entity would recognize a reduction to partnership equity instead of compensation cost.

***EITF Issue 00-23***

44. Although there is currently no authoritative guidance that addresses profits interests by name, the EITF has previously provided guidance for profits interests in the context of stock compensation accounting.

45. Despite having been superseded by Statement 123R, the guidance in EITF Issue 00-23 continues to be referenced frequently in nonauthoritative guidance, including firm publications, for areas of stock compensation accounting where its guidance is more directly on point than the guidance in Topic 718.

46. EITF Issue 00-23 discussed profits interests in the following two issues:

(a) Issue 40(a): Whether a grantee who provides services to an LLC (or other pass-through entity) should be considered an employee for purposes of accounting for capital- or equity-based compensation (profits interest awards) granted by the LLC

(b) Issue 40(b): If a grantee of a profits interest award is considered to be an employee for purposes of applying Opinion 25 (including by analogy), whether that award should be accounted for as fixed or variable.

47. A key message of the guidance in EITF Issue 00-23, consistent with the SEC speech, was the importance of focusing on the substance of the awards rather than the legal form.

> The Task Force observed that the terms of a profits interest award vary from plan to plan. Depending on the terms of the profits interest award, that interest may be similar to the grant of an equity interest (restricted stock that is subordinate to existing equity), a stock option (the right to purchase an interest at a future date at a specified strike price), a stock appreciation right (the right to receive, in cash, an amount equal to the appreciation in the fair value of an underlying profits interest), or a profit-sharing arrangement.

**Nonauthoritative Guidance**

***SEC Speech on Special Classes of Stock Granted to Employees***

48. As discussed above, the agenda request references language in the SEC speech for determining whether profits interests are accounted for within the scope of Topic 718 or Topic 710.

49. The term *substantive class of equity*, mentioned in the SEC speech, does not appear in Topic 718 and is not described within Topic 718 as a condition that would assist an entity in determining whether the arrangements are within the scope of Topic 718. Furthermore, the SEC speech did not mention or directly reference the two criteria (payment based, at least in part, on the price of the entity's equity shares or settled in the entity's equity instruments) that appear in paragraph 718-10-15-3.

50. Because the SEC speech does not discuss how its factors relate to the scope guidance in Topic 718, the staff also researched the extent to which the factors mentioned in the SEC speech align with the typical terms of a profits interest.

*Few, If Any, Assets Underlie the Special Class or the Holder's Claim Is Heavily Subordinated*

51. The SEC speech indicates "[w]hen few if any assets underlie the special class, or the holder's claim to those assets is heavily subordinated, the arrangement often has characteristics of a performance bonus or a profit-sharing arrangement." The SEC speech does not further describe precisely what was meant by the phrase "few if any assets underlie" a class of equity.

52. The staff notes that the tax definition of a profits interest prohibits a right to proceeds in a liquidation that occurs immediately following grant. If a partnership interest were able to participate in proceeds from an immediate liquidation, the interest granted would not be a profits interest. Instead, it would be a capital interest.

53. The SEC speech also states that another characteristic that indicates that a special class of equity is not a "substantive class of equity" would be if the holder's claims to any assets that underlie the special class are "heavily subordinated." *Equity*, as defined in FASB Concepts Statement No. 6, *Elements of Financial Statements*, is the residual interest in the assets of an entity that remains after deducting its liabilities. A residual interest typically represents the most subordinated interest in an entity's assets. This concept has been acknowledged in other standards in the past. For example, the following is an excerpt from paragraph 810-10-55-23 related to consolidation:

> For a voting interest entity the most subordinated interest is the entity's equity; for a VIE it could be debt, beneficial interests, equity, or some other interest.

*Substantive Voting Rights*

54. The SEC speech notes that "instruments that provide the holder with substantive voting rights…are at times indicative of an equity interest." The staff notes that equity interests often contain substantive voting rights, but that it is not uncommon for equity interests to lack voting rights. For example, some publicly traded corporations have share classes with either no voting rights or voting rights that are not proportionate to the share's economic rights. Other types of share-based payments, such as stock appreciation rights, also may not provide voting rights to the grantee.

55. As discussed in PCC Memo 2, profits interests, particularly those issued by private equity portfolio holding companies, rarely provide the holder with voting rights.

*Pari Passu Dividend Rights*

56. The SEC speech states that the presence of *pari passu* dividend rights (that is, multiple classes of equity shares that have equal rights to dividends) is "indicative of an equity interest." The agenda request, however, notes that profits interests are sometimes so heavily subordinated that they are not likely to participate in operating distributions, and instead require a sale or IPO to realize proceeds.

57. Moreover, the staff's research of practitioner publications indicates that profits interests are sometimes explicitly structured so that the holders only participate in proceeds from a liquidation or sale and are never entitled to operating distributions.[6] In general, the staff's research indicates that awards that only participate in proceeds upon a sale or IPO are actually more likely to be considered share-based payments in practice than awards that only provide the holder with rights to operating distributions while they are employed by the grantor because the amount received upon a sale or IPO is often indexed to the price of the entity's equity shares.

[6] Practical Law Company Publication, *Partnership Equity Compensation.* https://www.fdh.com/bulletin/partnership_equity_compensation.pdf. See section "Comparison to Cash Deferred Compensation Plans."

*Investment Required*

58. The SEC speech also noted that "consideration should also be given to any investment required…." However, the SEC speech did not elaborate further as to how a required investment would factor into the analysis.

*Put and Call Rights*

59. The SEC speech notes that "put and call rights that may limit the employee's downside risk or provide for cash settlement" should be given consideration as well.

60. The staff's research and past outreach has indicated that put and call rights are common in awards of profits interests and can influence the substance of the awards. Therefore, the staff understands that the effect of any put or call options is considered in practice when assessing the scope of profits interest awards.

***Practitioner Publications***

*Substantive Class of Equity*

61. Due to the lack of authoritative guidance that specifically addresses profits interests, a significant volume of nonauthoritative guidance has been published by practitioners to assist in determining the appropriate scope of guidance. This section of the memo discusses how firm publications sometimes refer to the guidance in paragraph 718-10-15-3 for determining whether a profits interest is within the scope of Topic 718, while others, in line with the SEC speech, emphasize whether a profits interest represents a substantive class of equity.

62. The staff reviewed eight firm publications (four Big 4 publications, two guides from global firms, and two guides shared by national firms that are not publicly available) that discuss whether profits interests should be accounted for as share-based payments under Topic 718 or as deferred compensation arrangements under Topic 710. Of those eight publications, six explicitly reference the SEC speech and three point to the determination of whether an interest is a "substantive class of equity" as part of determining whether an award is within the scope of Topic 718 or Topic 710.

63. The discussions of the relationship between the guidance in paragraph 718-10-15-3 and the "substantive class of equity" determination vary. For example, some publications note that the appropriate scope of guidance is a function of whether the criteria in paragraph 718-10-15-3 are satisfied and that the substantive class of equity determination does not override the guidance in Topic 718. Others assert that whether a profits interest is within the scope of Topic 718 hinges on whether it is a substantive class of equity. The staff has excerpted examples of published guides that depict this distinction.

64. Grant Thornton's guide, *Share-Based Payments, Navigating the guidance in ASC 718* (April 2021),[7] states that the guidance in paragraph 718-10-15-3 should be considered first, and determining whether an interest is a substantive class of equity is a secondary consideration.

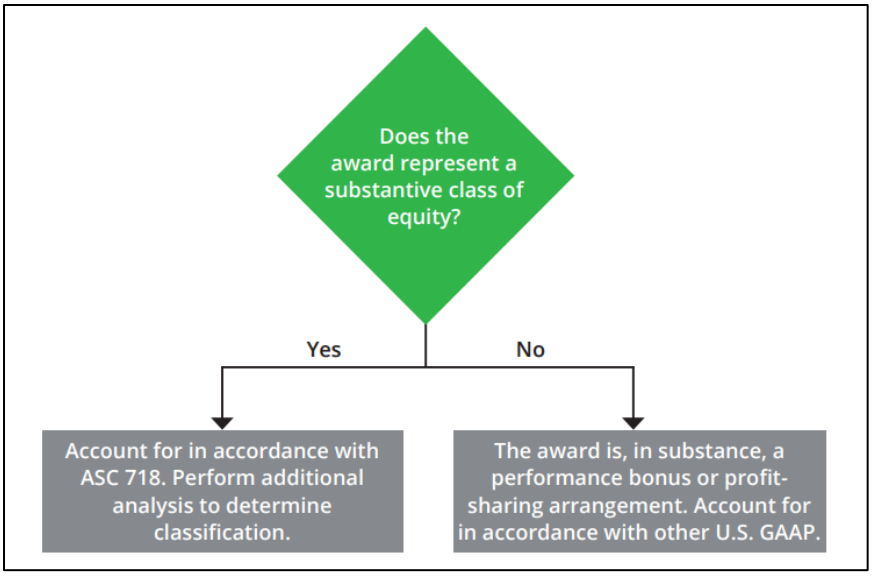
> **3.4** Regardless of the nomenclature used in award agreements, such as profits interests or incentive interests among many other terms, entities must determine whether the instrument should be accounted for in accordance with ASC 718 or other guidance. To make this determination, all features of the award should be considered.
>
> An entity must first determine whether the award is clearly within the scope of ASC 718. An award is within the scope of ASC 718 (as discussed in ASC 718-10-15-3) if the award is paid in the form of shares, share options, or other equity instruments to either a customer or to a grantee for goods or services to be used or consumed in the grantor's operations, and that payment is required to be settled in, or is based at least in part on the price of, the entity's shares or other equity instruments.
>
> If the award is not squarely within the scope of ASC 718-10-15-3, the entity should next determine whether the award constitutes a substantive class of equity or is instead, in substance, a performance bonus or profit-sharing arrangement. Because the guidance provides no bright lines or assigned weighting of indicators, an entity must consider all features of the award in making this determination.

65. EY's guide, *Financial Reporting Developments (FRD), Share-based payment (after the adoption of ASU 2018-07)* (May 2021),[8] also emphasizes that the determination of whether a profits interest is within the scope of Topic 718 is based on whether the "payment under the arrangement is required to be settled, at least in part, on the price of the entity's shares or other equity instruments," consistent with paragraph 718-10-15-3. EY's guide uses some of the factors cited in the SEC speech for determining whether an interest that is already determined to be within the scope of Topic 718 should be "liability- or equity-classified in accordance with [Topic] 718."

66. Other guides explicitly point to the determination of whether a profits interests represents a substantive class of equity as the determining factor for whether a profits interests is within the scope of Topic 718 or Topic 710. For example, the Deloitte publication, *A Roadmap to Accounting for Share-Based Payment Awards,*[9] directly connects the substantive class of equity determination with the appropriate scope of guidance.

> 2.6 While the legal and economic form of [profits interests] can vary, they should be accounted for on the basis of their substance. If an award has the characteristics of an equity interest, it 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 as such in accordance with other U.S. GAAP (e.g., typically ASC 710 and ASC 450 for employee arrangements).

[7] Grant Thornton: Share-Based Payments, Navigating the guidance in ASC 718
[8] EY: Financial Reporting Developments, Share-based payment
[9] Deloitte: A Roadmap to Accounting for Share-Based Payment Awards




67. Similarly, a practitioner publication that is not publicly available states that whether a profits interest is within the scope of Topic 718 or Topic 710 hinges on whether the interest represents a substantive class of equity. However, that guidance also points back to aspects of the guidance in paragraph 718-10-15-3 for making this determination.

> **Practice Note**: A settlement amount that is based, at least in part, on the fair value of the entity is often viewed as a persuasive 718-like characteristic.
>
> Management should clearly document how factors were weighted and how judgment was applied in concluding on the substance of the award. Profits interest awards to employees that are not a substantive class of equity should be accounted for as a compensation arrangement under Topic 710. In contrast, profits interest awards to employees that are a substantive class of equity are in the scope of Topic 718.

*The Ability to Retain Vested Interests*

68. Although there is inconsistency in how firms emphasize the importance of the substantive class of equity determination, there is more consistency in which factors are cited to determine whether a profits interest is within the scope of Topic 718.

69. All eight firm publications reviewed by the staff note that whether vested interests are retained after termination without cause is a factor for determining whether a profits interest is within the scope of Topic 718. This factor, when discussed in firm publications, was usually the most heavily weighted factor.

70. Although this factor is not mentioned or described in either the Codification or the SEC speech, firms tend to place significant emphasis on this criterion. For example, Deloitte's guide sets forth 11 different factors to consider when making the determination of whether a profits interest represents a substantive class of equity, but places special emphasis on whether vested interests are retained after termination.

2.6 **A key focus in the determination of whether profits interests represent a substantive class of equity is the ability to retain residual interests upon vesting, including after termination.** This includes the ability to realize value that is tied to the underlying value of the entity's net assets, through distributions that are based on an entity's profitability and operations as well as on any liquidity event (even if through a lower level of waterfall distributions). **By contrast, in a profit-sharing arrangement, a grantee typically is only able to participate in the entity's profits while providing goods or services to the entity, and a residual interest is not retained upon termination.** A profit-sharing arrangement may also contain provisions (e.g., repurchase features) that limit the grantee's risks and rewards (e.g., a repurchase feature that, upon termination of employment, is at cost or a nominal amount)….

**In addition, not all the indicators described above are given equal weight.** While voting rights and transferability may be indicative of an equity interest, the absence of such features would not preclude the interest from being considered a substantive class of equity….

In determining whether a vested residual interest is retained after termination, an entity typically focuses on what happens to the interest if the grantee is an employee who voluntarily terminates employment without good reason or if the grantee is a nonemployee who ceases to provide goods or services. For example, if an employee award is legally vested but is substantively forfeited upon voluntary termination without good reason…the award will most likely be a profit-sharing arrangement…. [Emphasis added and footnote reference omitted.]

71. Other firms tend to place additional emphasis on this factor either explicitly or implicitly through examples where the determination on scope is dependent on whether vested interests are retained after termination without cause. That is, in all examples reviewed by the staff, a profits interest that participates in proceeds upon a sale or liquidation and can be retained by the grantee after vesting following voluntary termination or termination without cause are asserted to be within the scope of Topic 718. The following example is from the KPMG *Share-Based Payments Handbook* (July 2021).[10]

**Q&A 4.27: Award of Profits Interests – Part II**

**Background**

An employee is granted a Class B profits interest award in its LLC employer. The membership interests vest ratably over a four-year period. If the employee terminates employment, the unvested membership interests will be forfeited for no consideration.

The employer has a call option to repurchase vested units at fair value. In addition, the terms of the repurchase feature provide the LLC the ability to delay repurchase until the employee has been exposed to risks and rewards of ownership for a reasonable period of time.

The LLC's organizing documents describe a waterfall as to how the fair value of the entity will be allocated to the different classes of equity as follows:

(a) Return of capital invested to the Class A units;

(b) Compounded rate of return at 12% to the Class A units;

[10] KPMG: Handbook: Share-based payments

(c) Residual amount shared proportionately between the Class A units and the Class B profits interests.

**Q. Is this unit a share-based payment?**

**A.** Yes. This instrument represents an equity interest in the LLC because the employee has an interest in the net assets of the company at grant date. Specifically, the arrangement provides the employee with rights associated with having membership interest in the LLC. Employees have rights to participate in the residual net assets of the entity upon dissolution or liquidation proportionate to Class A profits interests. **In addition, subject to vesting conditions, the employee retains his or her vested membership interest under the arrangement upon termination of service, subject to repurchase at fair value by the employer.**

Therefore, the LLC should account for the awards as a share-based payment and should recognize compensation cost over the requisite service period.

72. The following similar example is from the guidance in PwC's *Stock-Based Compensation Guide* (September 2021).[11]

**EXAMPLE SC 6-2 Grant of profits interest award that can be held beyond termination**

SC LLC grants a profits interest award to its employee. The award vests ratably over a four-year period. Once vested, the holder is entitled to distributions and liquidation and pre-emptive rights proportionate to their ownership interest, and participates in the same form of consideration as other equity holders in the event of a sale of the entity. If the employee voluntarily leaves employment or is terminated without cause, SC LLC has a call option to repurchase the vested interests at fair value on the repurchase date. SC LLC has the ability to delay the repurchase of the vested interests for at least six months to allow the employee to bear the risks and rewards of ownership. Unvested interests are forfeited for no consideration upon termination.

**How should SC LLC account for this profits interest award?**

**Analysis**

While all facts and circumstances should be considered, SC LLC would likely conclude that the profits interest award is a form of share-based compensation under ASC 718. The employee will participate in future operating and capital transactions of the entity in the same fashion as other equity holders, proportionate to their interest. **Upon termination, the employee can either retain their interest or it may be repurchased at fair value which, again, is consistent with bearing the risks and rewards of equity ownership.** Therefore, this award is likely a share-based payment in the scope of ASC 718. [Emphasis added.]

*Other Factors*

73. Although the ability to retain vested interests is generally emphasized in the firm publications, it is sometimes included in lengthy lists of factors that are part of the substantive class of equity determination. Each publication that places significant emphasis on the substantive class of equity determination also cites 10 or more total factors for determining the appropriate scope of guidance.

[11] PwC: Viewpoint: Stock-based compensation Guide

74. The factors included in the publications are similar to those used in the "facts and circumstances" approach described in BDO's agenda request. In some publications, it is not clear how the listed factors should be weighted or whether there are particular factors that override others. In other publications, it is clear that some factors are weighted more heavily than others.

*Interaction with Partnership Accounting*

75. Only one of the guides reviewed by the staff speaks to partnership accounting practices that may apply to awards of profits interests. EY's Share-Based Payment FRD notes that there are questions about whether interests issued by limited liability entities are a form of compensation or a distribution to a partner in their capacity as an owner.

> 5.2.8 Questions sometimes arise whether an interest in a limited liability entity is a form of compensation to an employee or a distribution to a partner in their capacity as an owner. Some factors to consider in determining whether the arrangement is a partner distribution or employee compensation include:
>
> - **Form of ownership**—If the individual has made a contribution and signed a partnership agreement that will provide for sharing in the profits and losses and distributions, and the individual receives a Schedule K-1 for tax purposes, the arrangement may be more akin to a partner arrangement. Alternatively, employee compensation classification may be appropriate if the individual's amount of ownership is conditioned upon providing a service or meeting a performance condition where the failure to meet the requirements will result in the partnership interest ceasing to exist.
>
> - **Governance of the partnership**—If the individual is part of a visible group that is known to have ultimate authority over the entity's direction, this is an indicator of a partner arrangement.
>
> - **Funding participation**—A partner generally is required to make a contribution based upon his or her percentage of ownership when capital is needed. Therefore, the arrangement may cover distribution of the results of the entity's operations to the partners in their capacity as owners.

76. The staff is not aware of other nonauthoritative guidance published by the practitioners that discusses the interaction of partnership accounting practices and profits interests.

**Prevalence in Public Business Entities**

77. The Master Glossary of the Codification defines a *public business entity* as a business entity (excluding not-for-profit entities and employee benefit plans) that would meet any of the following conditions:

> (a) It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).

(b) It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.

(c) It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.

(d) It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.

(e) It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including notes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

78. The Master Glossary definition also notes that an entity may meet the definition of a *public business entity* solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

79. Entities that file SEC Form S-1 Registration Statements are required to furnish financial statements meeting the requirements of SEC Regulation S-X. Therefore, an entity that furnishes financial statements as part of an S-1 Registration Statement filing meets the definition of a *public business entity*, even if the securities of the entity are not yet traded on public exchanges.

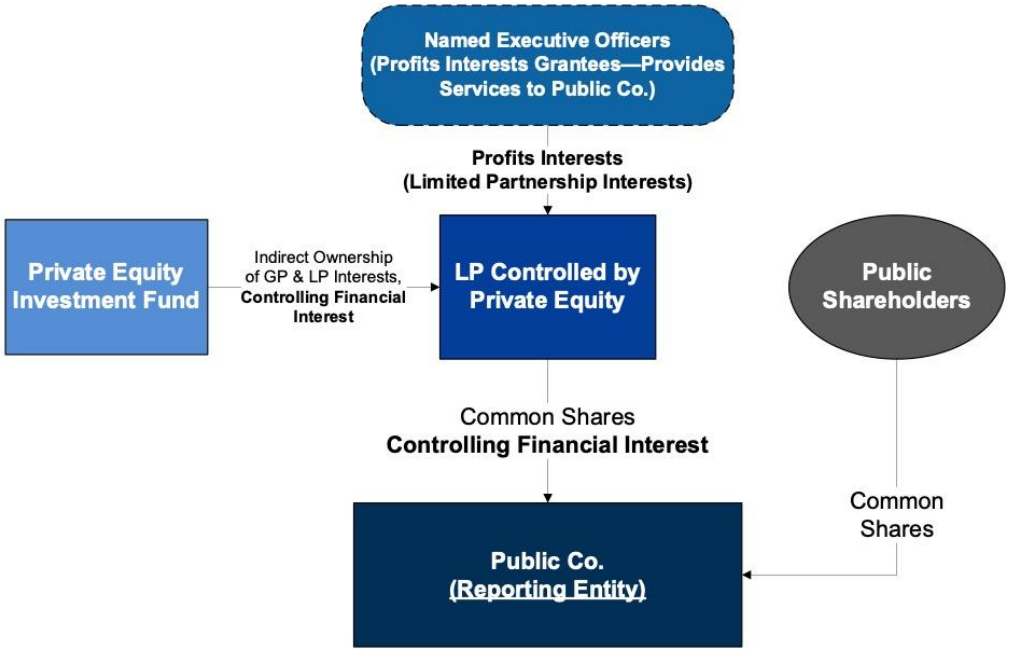
80. Public business entities cannot apply private company accounting alternatives and private company practical expedients. Currently, there is no relief for entities that apply a private company accounting alternative or practical expedient[12] and later satisfy the definition of a *public business entity*. Guides published by practitioners often note that entities in this position must present all periods in accordance with the guidance applicable to public business entities, which could involve retrospectively recasting financial statements prepared using private company practical expedients and alternatives. For example, Deloitte's publication, *A Roadmap to Accounting for Business Combinations*, includes a cautionary note for entities related to the use of private company practical expedients and alternatives:

> Before electing the private-company accounting alternatives, a private company should consider whether it might become a PBE in the future (e.g., the entity may file an IPO or may be required to have its financial statements included in a registrant's filing under SEC Regulation S-X, Rule 3-05). Neither the FASB nor the SEC has provided relief or transition guidance for private companies that have elected the private-company accounting alternatives and later become PBEs; thus, private companies that might become PBEs should be cautious about electing them. Private companies that do apply the accounting alternatives and later become PBEs would need to retrospectively remove the effects of the accounting alternatives in any financial statements filed with, or furnished

[12] *Private company practical expedient* and *alternative* are used in a manner consistent with their definitions in the *Private Company Decision-Making Framework, A Guide for Evaluating Financial Accounting and Reporting for Private Companies*, and do not necessarily contemplate guidance developed for nonpublic companies prior to the establishment of the PCC.

to, the SEC. The removal of such effects could become increasingly complex as more time passes.

81. During the June 22, 2021, PCC meeting, the staff presented an example company that had granted profits interests to its named executive officers (NEOs) prior to filing a Form S-1 Registration Statement and subsequently completed an IPO. The profits interests granted by the entity (including its related parties) remained outstanding after the entity completed its IPO. While public companies that are legally organized as C-Corporations cannot directly grant profits interests, other related parties including parent and subsidiary companies may be organized as pass-through entities that can grant profits interests in exchange for the services provided to the public company, including its subsidiaries.




82. The staff noted during that meeting that it would continue to research the prevalence of profits interests affecting the financial statements of public business entities. The staff understands that some entities structured as LLCs or LPs (or that have parent or subsidiary entities structured as LLCs or LPs that grant the profits interests to the reporting entity's service providers) grant profits interests before filing a Form S-1 Registration Statement and completing an IPO. Outreach indicated that typically, profits interests do not survive an IPO and are either settled or replaced with economically similar equity awards (such as stock options or restricted share units).

83. While the staff understands that it is atypical for profits interests to survive an IPO, as noted above, an entity that has not yet "gone public" will be a public business entity for the purpose of financial statements included in a Form S-1 filing. For entities that have not yet completed an IPO, it is more likely for any profits interest awards to remain outstanding (or for the related compensation cost to be reflected in comparative periods presented).

84. To better understand the prevalence of profit interests granted for goods or services by public business entities, the staff gathered data about every company that filed a Form S-1 between January 1, 2021 and September 17, 2021. During that time period, approximately 1,600 different companies filed Form S-1 with the SEC.[13,14] Of that group of companies, the staff queried how many of those companies used the phrases "profits interests," "profit interests," "profit interest," or "profits interest" in the S-1 filing itself (the staff's query excluded the use of those phrases in the exhibits to the S-1 filings). The initial results included 117 companies that used one or more of those phrases in their Form S-1 filing. The staff manually reviewed each of the 117 Form S-1 filings that contained those phrases to exclude any uses of the term that did not indicate that the entity had granted profits interests for goods or services (for example, when used only in a legal definition included in the filing). The remaining population included 93 companies, or approximately 6 percent of the 1,600 companies that filed a Form S-1 Registration Statement between January 1, 2021 and September 17, 2021.

85. While the staff does not have data on the number of profits interests granted by private companies, the staff understands from outreach that entities that must account for profits interests in their financial statements are predominantly private companies. However, the staff's research indicates there is a non-insignificant population of companies that grant profits interests and later become public business entities upon furnishing financial statements in an S-1 filing.

86. Furthermore, the staff's research and outreach has indicated that profits interests are commonly granted to executives at private equity portfolio companies. Private equity firms often consider an exit strategy that involves a public listing and, in 2020, the dollar value of public listings grew significantly compared to 2019.[15]

## Summary of Outreach

87. From June 2021 to October 2021, the staff and Working Group conducted outreach with 21 stakeholders from the following categories:

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[13] As discussed in Deloitte's 2019 Publication, A Roadmap to Initial Public Offerings, a Form S-1 may be filed by a company that has already completed an IPO. For example, this guide notes in Section 7.7.1., that

> The Form S-1 registration statement is used (1) when no other form is prescribed by SEC rules and (2) by all issuers that have not previously filed under either the Securities Act or the Exchange Act or that have been in the Exchange Act reporting system for less than 12 months. A newly public company may use Form S-1 for a follow-on offering in which the company offers additional registered shares to the public or registers privately held shares of the company's founders, board of directors, or other large shareholders so that those shares may be sold in the public market.

[14] The companies that filed an S-1 during this period include Foreign Private Issuers (that provided financial statements presented in accordance with International Financial Reporting Standards) and special-purpose acquisition companies (SPACs). The staff has not determined what proportion of the 1,600 companies fall into either of these categories but notes that their exclusion would result in a greater proportion of S-1 filers having profits interests discussed in their filing.

[15] https://files.pitchbook.com/website/files/pdf/2020_Annual_US_PE_Breakdown.pdf

(a) Practitioners: Big 4, global, national, regional, and consultancy firms

(b) Users: Private equity/venture capital and asset management firms

(c) Preparers: Private equity backed and other partnership/pass-through entities

(d) Regulator.

The table below summarizes the outreach participants:

| **Stakeholder Type** | **Participants** |
|---|---|
| Practitioner | 13 |
| Preparer | 5 |
| User | 2 |
| Regulator | 1 |
| **Total Stakeholders** | **21** |

88. The purpose of this outreach was to solicit feedback on multiple issues associated with profits interests, including the following issues associated with determining the scope of guidance applicable to profits interests:

(a) Types of entities that grant profits interests

(b) Diversity in practice

(c) Implications for partnership accounting practices

(d) Need for standard setting

(e) Potential solutions.

**Types of Entities That Grant Profits Interests**

***Practitioners***

89. All practitioners noted that they encounter a substantial majority of profits interests in private equity backed pass-through entities (for example, LLCs and LPs); two participants volunteered that 90 percent or more of their profits interest experience related to those types of entities. Additionally, outreach participants noted experience with profits interests in other types of pass-through entities, such as asset management companies and family-owned partnerships (where profits interests are used similarly to employee stock ownership plans (ESOPs). One practitioner noted that profits interests could potentially be granted by any pass-through entity.

90. The staff and Working Group members asked outreach participants how frequently public business entities account for profits interest awards before and after an IPO. Practitioners noted that profits interests generally are not granted by public business entities (profits interests are sometimes granted by private companies that later become public business entities). If profits interest awards exist before a public offering transaction, such as an IPO, the awards do not usually survive the transaction. Most practitioners noted that when profits interests are granted before an IPO, the profits interests are either (a) structured to be settled upon a business combination or exit or (b) converted to other types of equity awards. Two practitioners noted that profits interests sometimes survived Up-C transactions.[16]

***Preparers***

91. All five of the preparers who the staff spoke with represented private equity backed companies.

***Users***

92. One of the users the staff spoke with generally encountered profits interests in the context of private equity, including for portfolio companies of his current private equity firm. Another user noted that the portfolio companies they analyze generally granted options and/or restricted stock units as opposed to profits interests. That user noted that his experience with profits interests related to the carried interests granted by the private equity fund to the general partner and the interests the general partner granted to individuals.

***Regulator***

93. The regulator noted that while profits interests normally do not survive an IPO, they sometimes remain outstanding, including as part of an Up-C transaction.

**Diversity in Practice**

***Practitioners***

94. Almost all practitioners indicated that profits interests are predominantly accounted for under Topic 718, particularly when granted to management of private-equity portfolio companies. Large-to-medium sized practitioners provided mixed views on whether they viewed determining the appropriate scope of guidance for profits interests to be a significant challenge. Conversely, small-to-medium sized practitioners generally viewed determining the appropriate scope of guidance for profits interests to be

[16] Per KPMG, Executive View, *Unlocking value beyond the traditional IPO* (September 2019),

> An umbrella partnership C corporation (Up-C) structure enables owners of a flow-through entity (such as a limited partnership or limited liability company) to conduct an initial public offering (IPO) via a newly formed C corporation, which ultimately holds only an equity interest in the flow-through entity.

a significant challenge. Specifically, smaller practitioners and one global firm generally noted that the primary issue encountered when accounting for profits interests is determining the appropriate scope of guidance. The global firm emphasized that they found the degree of diversity in practice across firms to be concerning.

95. When discussing the evolution of this issue over time, larger practitioners indicated that practice has generally coalesced around a common set of considerations for evaluating profits interests and that challenges in identifying the appropriate scope of guidance are not as acute as they were in 2018 when BDO submitted its agenda request. Additionally, one practitioner noted that the terms of profits interests have generally become more standardized over time and tend to reflect characteristics that more clearly align with either Topic 710 or Topic 718. That practitioner noted that one group of awards tends to have a stated service period and a high distribution hurdle, and the other group of awards tends to be akin to a profit-sharing program with low or non-existent distribution hurdles. The consultant noted that the second group of awards typically cannot be retained by the grantee upon termination.

96. While large firms often have developed interpretative guidance that they refer to in practice, those firms that do not publish their own guidance tend to refer to other firm guides to supplement the guidance in Topic 718. One Big 4 firm noted that determining the appropriate scope of guidance is not challenging for a practitioner who encounters them frequently, but that preparers may find this assessment to be challenging, especially when referring only to the guidance available in the Codification, which does not specifically discuss profits interests. Moreover, multiple practitioners noted that profits interests are an area for which audit teams are required to consult with firm specialists.

97. One U.S. regional firm noted that they refer to a Big 4 firm guide when determining the appropriate scope of guidance and noted that nearly all of the profits interests that they encounter are accounted for in accordance with Topic 710. That practitioner noted that this determination is not particularly cumbersome.

98. Large-to-medium sized practitioners also noted that, when determining the appropriate scope of guidance, reliance on the factors in the SEC speech ranged from moderate reliance to little or no reliance. In addition to the factors in the SEC speech, practitioners indicated that they refer to the scoping guidance in Topic 718 and other factors discussed in nonauthoritative guidance published by the Big 4 and other firms. Of the factors not included in the SEC speech, the ability to retain vested interests and whether the settlement amount will be based on the fair value of the entity's equity are often heavily weighted.

99. Small-to-medium sized practitioners described a mixed level of reliance on the SEC speech. For example, one consultant does not place heavy reliance on the factors in the SEC speech because, in their view, many profits interests have clear features that align with Topic 718 scoping guidance and, therefore, do not need to reference the factors described in the "facts and circumstances" approach. In contrast, another consultant stated that the factors outlined in the SEC speech were helpful.

Additionally, one U.S. regional firm stated that it did not consider the SEC speech at all and instead referred exclusively to a single published firm guide.

100. One Big 4 firm and one U.S. national firm noted that analysis of available guidance has changed over time, including how certain factors from different guidance are weighted. Generally, outreach participants who considered other factors in addition to the SEC speech noted that the key message of the speech was to emphasize that instruments like profits interests should be accounted for in accordance with their substance, rather than their legal form.

101. Outreach indicated that there were differing interpretations of the meaning of certain factors in the SEC speech—for example, firms provided different views about the meaning of "when few if any assets underlie the special class," which the SEC speech notes is indicative of a profit-sharing or bonus arrangement (rather than a substantive class of equity). Some said that it was not useful to consider this factor when analyzing profits interests because a partnership interest that provides rights to existing assets when granted would not satisfy the tax definition of a profits interest. Others interpreted the same factor to mean that in multi-tiered structures in which the entity that grants the profits interests has only a right to contractual cash flows from a lower-tiered entity, the profits interests may not represent a substantive class of equity.

102. Two global firms noted that they do not place significant weight on whether the award holder is entitled to voting rights, which is one of the factors mentioned in the SEC speech—in accordance with the speech, the presence of voting rights indicates that an instrument is a substantive class of equity.

103. Outreach participants generally noted that applying the SEC speech to determine the appropriate scope of profits interest awards can be challenging. One Big 4 firm, one global firm, and two U.S. national firms noted that the SEC speech introduces elements that are not directly reflected in Topic 718. Another Big 4 firm stated that a preparer relying only on the SEC speech might arrive at a different conclusion if the preparer had not also reviewed the interpretive guidance prepared by the firm, which introduces additional factors to consider.

***Preparers***

104. Preparers expressed mixed views on the level of difficulty associated with determining the scope of guidance and the resulting diversity in practice resulting from that determination. Two preparers noted that determining the scope of guidance is challenging and requires judgment, while three preparers did not view this determination to be challenging.

105. Those preparers who view the scope of guidance determination to be challenging asserted that there is diversity in practice on the proper accounting treatment of profits interest awards. One preparer noted that they discuss this issue in depth with their auditor when determining the appropriate scope of guidance. That preparer ultimately concluded that the awards granted by their company should be

accounted for under Topic 710. In contrast, another preparer noted that while significant judgment is required to determine the scope of guidance, they determined that their profits interest awards should be accounted for under Topic 718. That preparer noted that accounting for an award in accordance with Topic 718 may be more difficult than accounting for the same award under Topic 710, which the preparer thought could influence the scope of guidance determination.

106. Preparers who did not view the scope of guidance determination to be challenging noted that they account for profits interest awards in accordance with Topic 718. For example, one preparer noted that they account for profits interests in accordance with Topic 718 because of the awards' characteristics (such as vesting terms and participation in equity appreciation), which function similarly to a stock option plan.

***Users***

107. Users did not express views on the diversity in practice when determining the appropriate scope of guidance when accounting for profits interests.

***Regulator***

108. The regulator indicated an awareness of the challenges associated with determining the appropriate scope of guidance when accounting for profits interests. When evaluating the appropriate scope of guidance for accounting for profits interests, the regulator indicated that considering the substance of the arrangement is important.

**Implications for Partnership Accounting Practices**

109. The staff and Working Group posed questions to stakeholders to better understand whether establishing guidance that directly addressed the accounting for profits interests would result in unintended consequences for companies that apply partnership accounting practices. The staff understands that under partnership accounting practices, certain compensation paid to owners may not result in expense recognition and would instead be accounted for as a capital transaction (for example, as a distribution of equity similar to a dividend).

110. The staff and Working Group sought to understand (a) whether the stakeholders had encountered transactions involving profits interests or economically similar arrangements that were not accounted for under Topic 710 or Topic 718 and instead were accounted for as capital transactions between the partnership and its owners and (b) whether they thought existing practice would be disrupted by references to profits interests in potential future guidance. The staff and Working Group also posed questions to understand whether stakeholders encountered instances in which changes in the

allocations of profits between existing partners (economically akin to granting a "pure profits interest" to one of the partners) are viewed similarly to or differently than grants of profits interests in practice.[17]

***Practitioners***

111. Most practitioners stated that they were not aware of any implications for partnership accounting practices that would arise if a project were added to the agenda to address the appropriate scope of guidance applicable to profits interests. Most practitioners stated either that they did not think that providing guidance for determining the appropriate scope of profits interests would affect entities applying partnership accounting practices or that they did not encounter entities applying partnership accounting practices. One practitioner also noted that while they have not encountered instances in which existing rights to profits and losses have been reallocated as a form of compensation akin to a grant of a profits interest, "one could argue that it is not much different than a profits interest that should be compensatory." That practitioner also stated that they were not sure what conclusions were being reached in practice for this issue.

112. However, a few practitioners acknowledged that certain types of firms, primarily private investment advisors and service partnerships may be applying partnership accounting practices. One of those practitioners asserted that the SEC generally expects any equity interests provided as compensation to be reflected in compensation cost for such entities when appropriate. That practitioner also noted that some private companies may still be using partnership accounting practices and that this is supported by "legacy memos" that "quote accounting textbooks." Another practitioner also acknowledged that partnership accounting may be used by some investment advisors but noted that they did not see this frequently because investment advisors often do not issue standalone financial statements.

***Preparers***

113. Preparers generally did not identify potential implications for partnership accounting practices. When provided with a fact pattern illustrating how partnership accounting practices could be affected by potential standard setting, preparers indicated they had no experience with that fact pattern.

***Users***

114. Users noted that it could be challenging to define profits interests in a potential project to avoid unintended consequences on partnership accounting practices. Specifically, one user noted that they

[17] A pure profits interests is distinguished from "a capital interest with an attendant right to profits" or "a restricted capital with profits interest." See Postlewaite, Philip F., "Fifteen and Thirty Five--Class Warfare in Subchapter K of the Internal Revenue Code: The Taxation of Human Capital Upon the Receipt of a Proprietary Interest in a Business Enterprise" (2008). Faculty Working Papers. Paper 170. http://scholarlycommons.law.northwestern.edu/facultyworkingpapers/170

strongly preferred that partnership accounting, including at the investment advisor level, remain untouched because it currently functions effectively. Users did not, however, provide specific feedback on how to avoid unintended consequences to partnership accounting practices.

***Regulator***

115. Feedback from the regulator did not indicate a concern about implications for partnership accounting practices.

**Need for Standard Setting**

***Practitioners***

116. Overall, most practitioners expressed the view that standard setting could improve existing authoritative guidance and reduce diversity in practice for determining the appropriate scope of guidance. Overall, the firms that supported standard setting noted either that they thought applying the existing guidance was challenging or that there was diversity in practice because larger firms and smaller firms were not necessarily aligned on how to determine the appropriate scope of guidance. Practitioners sometimes expressed the view that a "list of factors" (similar to those applied in the "facts and circumstances" approach described in the BDO Agenda Request) was not as helpful as a framework would be.

117. Practitioners who supported standard setting expressed mixed views on the importance and urgency of the standard setting. Some practitioners noted that standard setting in this area is important, would be helpful, and would reduce diversity in practice, but others stated that standard setting in this area was a relatively low priority area.

118. Some practitioners did not support any standard setting in this area. The firms that did not support standard setting generally pointed to award terms becoming more consistent across entities and practice coalescing around interpretations that more closely align to the existing authoritative guidance in Topic 718. One of the practitioners who did not support standard setting in this area asserted that they did not think it was difficult to determine the appropriate scope in most fact patterns. However, that practitioner described interpretations of nonauthoritative guidance that frequently led them to determine that nearly all profits interests were in the scope of Topic 710—other practitioners who described similar fact patterns noted that the profits interests were typically within the scope of Topic 718.

***Preparers***

119. The preparers who expressed the view that the scope of guidance determination is challenging stated that the primary drivers of this challenge are that the guidance is complex and that profits interests can have characteristics consistent with both Topic 710 and Topic 718 and, therefore, supported potential standard setting.

120. Other preparers expressed the view that the scope of guidance determination is not particularly challenging and, therefore, did not support potential standard setting in this area.

***Users***

121. Users did not express views on whether standard setting was needed to help entities determine the appropriate scope of guidance for profits interests.

***Regulator***

122. The regulator did not express a view on whether standard setting was needed to help entities determine the appropriate scope of guidance for profits interests.

**Potential Solutions**

***Practitioners***

123. Practitioners of all sizes who supported standard setting generally indicated that the authoritative guidance could be improved by providing on-point guidance for determining the scope of guidance applicable to profits interest awards. Suggestions for improving authoritative guidance in this area included adding implementation guidance, illustrative examples, and decision-making frameworks. For example, one Big 4 firm thought that diversity could be eliminated through examples and other on-point guidance that would "codify practice." Specifically, practitioner feedback indicated that it would be helpful to provide guidance on how to weight factors and features when making the scope of guidance determination. Additionally, one U.S. national firm suggested that any solutions consider the substance of an award to avoid differential accounting attributable to "distinctions without a difference."

***Preparers***

124. The preparers who the staff and Working Group spoke with did not provide specific potential solutions.

***Users***

125. Users did not express views on the need for standard setting for the determination of the appropriate scope of guidance for accounting for profits interests and, therefore, did not provide potential solutions in this area.

***Regulator***

126. Feedback from the regulator indicated that if standard setting results in a private company accounting alternative or practical expedient for profits interests, an entity would likely be required to unwind the

alternative or expedient if it later pursued an IPO. The regulator also indicated that having to unwind a private company alternative or practical expedient upon an IPO may affect the rate at which private companies utilize any potential guidance.

## Next Steps

### Profits Interest Award Scope Issues (Discussed in This Memo)

127. During the first quarter of 2022, the PCC Technical Agenda Consultation Group is expected to meet and will discuss the merits of a potential project and whether it is more efficient and effective for the PCC or the FASB to take the lead on a potential project (that is, add the project to its respective technical agenda). The PCC decides whether to add a project to its technical agenda.

128. During the April 2022 PCC meeting, the PCC is expected to decide whether to (a) add a project to its technical agenda, (b) recommend that the Board add a project addressing this issue to its own technical agenda, or (c) decline to add a project on this issue.

129. The materials that the staff will prepare for discussion with the PCC Technical Agenda Consultation Group and the PCC will include an analysis of the agenda decision criteria. That analysis will discuss which approaches might represent technically feasible solutions. That analysis also will discuss whether there is an identifiable and sufficiently pervasive need to improve GAAP and whether the issue has an identifiable scope.

### Other Issues (Implied Performance Conditions, Classification, and Measurement)

130. During a future meeting, the staff will provide a complete summary of the research, including outreach, conducted on other issues that more broadly pertain to accounting for share-based payment arrangements in the scope of Topic 718.

# Appendix A: BDO Agenda Request Letter

AR-2018
Comment Letter No. 25



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October 8, 2018

Via email to director@fasb.org

Susan M. Cosper
Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

**Re: FASB Agenda Submission - Profits Interests treatment under ASC 718 or ASC 710**

Dear Ms. Cosper:

Please refer to the attached agenda request on the topic of whether certain equity interests in a partnership and similar legal structures are subject to ASC 710, *Compensation-General*, or ASC 718, *Compensation-Stock Compensation*.

We would be pleased to discuss our comments with the FASB staff. Please direct questions to Jin Koo at (214) 243-2941 or jkoo@bdo.com and Jennifer Kimmel at (617) 239-7019 or jkimmel@bdo.com.

Very truly yours,

BDO USA, LLP

BDO USA, LLP

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**Issue:** Whether certain equity interests in a partnership and similar legal structures are subject to ASC 710, *Compensation-General*, or ASC 718, *Compensation-Stock Compensation*.

**Background:**

Private entities often issue a special class of equity instruments or shares (collectively, "shares") to employees to more closely align the compensation of employees with the operating performance of entities. The purpose of the shares is often to give employees the opportunity to participate in the upside of the entity upon an initial public offering or a sale or perhaps an incentive to assist the entity to achieve a specific operating metric.

A common type of such shares, known as "profits interests", are primarily issued by partnerships or limited liability companies (LLCs), and are often described in legal agreements as "management units" or "class X units," where "X" refers to the class of equity and often to the relative level of subordination. Such awards are often moderately to highly subordinated to other classes of securities or interests in the entity. These profits interests represent a legal form of equity, but their characteristics vary such that they may be, in substance, akin to a performance bonus or a profit-sharing arrangement. Other common characteristics of profits interests include:

- Management's intent is to award the recipient substantial compensation upon a sale, liquidity event (e.g., initial public offering or other change of control) or final liquidation of the entity.
- Profits interests have a relatively high distribution hurdle. Recipients of such profits interests generally will not receive partnership distributions in the normal course of business due to the high threshold of distribution required, and the level of subordination. Recipients are more likely to receive residual value upon a sale or liquidity event.
- Profits interests frequently have an explicit performance condition linked to a change in control, recapitalization, initial public offering, or other liquidity event.
- Profits interests may or may not have an explicit service condition required for vesting.
- Forfeiture provisions vary – some awards are forfeited upon separation from the company for any reason. Other awards include a call option at fair market value, calculated value, or some other amount.

**Accounting Issue and Current Practice:**

Are profits interests subject to ASC 710, *Compensation-General*, or ASC 718, *Compensation-Stock Compensation*? In other words, are the awards a share-based payment for accounting purposes, or are they instead similar to a performance bonus or profit sharing arrangement?

Currently in practice, entities that issue profits interests evaluate all of the terms, conditions, and characteristics of an award and apply judgment to determine if it should be accounted for pursuant to ASC 710 or 718.[1]

[1] In some cases, other guidance may apply. For example, an award meeting the definition of a derivative instrument, such as an option indexed to the stock of a sister company, would be subject to guidance in Topic 815.





The scope of ASC Subtopic 710-10 includes deferred compensation contracts specified by ASC 710-10-15-3 and 15-4, but excludes stock compensation plans (ASC 710-10-15-5e). Stock compensation plans are specifically addressed by Topic 718.

Key differences between the accounting models in Topics 710 and 718 include:

- Measurement bases: Topic 710 measures deferred compensation arrangements at present value at each reporting date if payment is probable and reasonably estimable, while Topic 718 generally requires measurement at fair value at grant date;
- Classification: Topic 710 requires liability presentation while Topic 718 provides a framework for evaluating whether an instrument should be classified within equity or liabilities;
- Presentation of subsequent distributions to instrument holders: Under Topic 710, cash distributions to instrument holders represent compensation cost, while under Topic 718, distributions to holders of vested awards are treated as capital transactions (e.g., dividends) and generally do not result in additional compensation cost (absent a modification or settlement).

The SEC staff has provided commentary on the matter. Joseph Ucuzoglu, Professional Accounting Fellow, Office of the Chief Accountant, U.S. Securities and Exchange Commission, addressed this scoping issue in his December 2006 speech at the 2006 AICPA National Conference on Current SEC and PCAOB Developments:

> *Several accounting issues arise when a special class of stock is granted to employees. First and foremost, one must look through the legal form of the instrument to determine whether the instrument is in fact a substantive class of equity for accounting purposes, or is instead similar to a performance bonus or profit sharing arrangement. When making this determination, all relevant features of the special class must be considered. There are no bright lines or litmus tests. When few if any assets underlie the special class, or the holder's claim to those assets is heavily subordinated, the arrangement often has characteristics of a performance bonus or profit-sharing arrangement. Instruments that provide the holder with substantive voting rights and pari passu dividend rights are at times indicative of an equity interest. Consideration should also be given to any investment required, and any put and call rights that may limit the employee's downside risk or provide for cash settlement.*
>
> *When the substance of the instrument is that of a performance bonus or profit sharing arrangement, it should be accounted for as such. In those circumstances, any returns to the employee should be reflected as compensation expense, not as equity distributions or minority interest expense. Further, if the employee remitted consideration at the outset of the arrangement in exchange for the instrument, such consideration should generally be reflected in the balance sheet as a deposit liability.*

As a result of the "facts and circumstances" based approach noted above, there is currently diversity in practice in how entities account for profits interests, either under ASC 710 or ASC 718. Similar awards with similar features may be accounted for differently, as demonstrated below.

Note: Refer to "Appendix B – Outcomes in Practice" for examples of the following outcomes.

***Outcome A:*** *A profits interest award is subject to ASC 710.*





An entity might conclude Outcome A is most appropriate because the terms and conditions of the award are more akin to a profit-sharing arrangement/performance bonus. Common characteristics cited supporting this conclusion:

- Few, if any, assets underlie the special class of units, or the holder's claim to those assets is heavily subordinated.
- The underlying security on which these profits interests are based may contain rights that differ from other equity instruments of the entity (for instance, no voting rights, lack of transferability, lack of pre-emptive rights).
- Profits interests often contain explicit or implicit cash-settlement features. Management's intent may be to provide a performance bonus by allowing employees to share in profits (but not losses) and distributions of the entity upon a liquidity event. Management's expectation or intent is often to settle the profits interests through a cash payout upon a liquidity event.
- Generally no initial investment is required of the employee, which limits the employee's risk of loss.

***Outcome B:*** *A profits interest award is subject to ASC 718.*

An entity might conclude Outcome B is most appropriate because the terms and conditions of the award are more akin to an equity interest. Common characteristics cited supporting this conclusion:

- Legal form of the security is equity. Hence, a literal read of paragraph 718-10-15-3(a) indicates Topic 718 applies because the value of the reporting entity's stock is relevant to the amount of the award, "at least in part."
- Distributions are commonly at the discretion of the company or are triggered by distributions to other investors reaching a specified "hurdle rate" and not legally contingent upon a liquidity event.
- Recipients are treated as partners in that they are eligible to receive quarterly tax distributions as determined by the company in the normal course of business, and in some cases, those distributions may accumulate for unvested awards that are credited in full upon vesting.
- Payment under the arrangement is based, at least in part, on the price of the company's shares or other equity instruments (718-10-15-3a). This is generally true because recipients will monetize their profits interests through a distribution upon a liquidity event which inherently contains a market condition.
- In practice, profits interests may be subject to negotiation and potential replacement upon a liquidity event (i.e., they are eligible to survive a change in control).
- Companies generally offer a separate discretionary cash bonus program.

**Recommendation:**

In order to reduce diversity in practice, and in the spirit of the FASB's goal of improving the usefulness of the information provided to the users of financial statements while reducing cost and complexity in financial reporting through the Simplification Initiative, we recommend that Section 710-10-15 be clarified to specify that all awards issued based on the underlying legal equity of the employer are excluded from the scope of ASC 710. For instance, paragraph 710-10-15-5e might be modified to state the following:





> *Stock compensation plans that are addressed by Topic 718, including awards such as profits interests that require or may require settlement by issuing the entity's equity shares or other equity instruments, or the amounts are based, at least in part, on the price of the entity's shares or other equity instruments.*

In this context, we see no reason why Topic 718 may not be applied to all profits interests.





**Appendix A to Potential New Issue– Criteria for Adding Items to the EITF Agenda**
**Potential New Issue: Profits Interests Treatment under ASC 718 or ASC 710**

1. **Does the issue have widespread relevance?**

   Yes. Many reporting entities (primarily partnerships and LLCs) issue profits interests and similar awards as incentive compensation.

2. **Is there significant diversity in practice?**

   Yes. The accounting treatment described in Outcomes A and B have both been observed in practice. Also, given the judgmental nature of the analysis, it is not unusual for different entities to reach different conclusions related to similar instruments.

3. **Is there conflicting guidance in existing U.S. GAAP?**

   There is currently no guidance on profits interests. Entities look to Topics 710 and 718 which do not provide clear scoping criteria for profits interests that may have characteristics of both stock compensation and deferred compensation.

4. **Is it likely the EITF will be able to resolve the issue in less than one year?**

   Yes, it is likely that the EITF could address this issue in less than one year.

5. **Is the issue related to a current FASB project? If so, is there a pressing need to provide related guidance on a timelier basis than that expected from the FASB's activities?**

   This issue is not related to a current FASB project, although it would be consistent with the current Simplification Initiative.

6. **Is it reasonably likely that the FASB would conclude that only one answer is acceptable?**

   The FASB may conclude that different outcomes are acceptable given certain fact patterns. As noted above, we believe that clarification of the scope (specifically, scope exclusions) of ASC 710 would reduce diversity in practice and make application of the guidance more operational.

7. **Is there an opportunity through addressing the issue to converge U.S. practices with international practices?**

   Although we understand that similar tax definitions exist in foreign jurisdictions, and that profits interests issued by entities subject to U.S. tax laws may affect accounting by a foreign parent company reporting under IFRS, we are not aware of any substantial differences in practice between U.S. GAAP and IFRS in this regard.

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**Appendix B - Outcomes in Practice**

The following scenarios illustrate the diversity in practice set forth in this Agenda Submission. Note that in the following scenarios, we have summarized key terms that serve as indicators that many entities consider in order to determine whether profits interests are more akin to share-based payments (ASC 718) or deferred compensation arrangements (ASC 710).

| | **Scenario 1** | **Scenario 2** |
|---|---|---|
| **General** | Company E, LLC was formed in 2013. In 2016, Company E issued 250,000 Class C common units to employees in the form of profits interests. Company E has also issued Class A preferred units, Class A common units, and Class B common units. | Company F, LLC issued 100,000 Class A profits interest units to members of management. Company F has also issued Class A preferred interests. |
| **Legal form of instrument** | Legal equity – profits interests within the meaning of Rev. Proc. 93-27. | Legal equity – profits interests within the meaning of Rev. Proc. 93-27 |
| **Voting rights** | Class C units are non-voting (vested and unvested units). Only Class A common unit holders are eligible to vote. | Class A profits interest units are non-voting (vested and unvested units). Only preferred unit holders are eligible to vote. |
| **Transferability** | No transfer rights for any classes. | No member may pledge or grant a security interest in any of its interests without the prior written consent of the managing member. |
| **Vesting and settlement conditions** | Class C units will vest at the end of each year over a period of 5 years based on achievement of specific EBITDA targets, subject to the recipient remaining in the employment of Company E. The EBITDA target is deemed a performance condition.<br><br>Additionally, upon a change in control, vesting of all units will be accelerated subject to attaining a certain threshold of equity value per the change in control event. This is deemed a market condition. | Class A profits interests vest at the end of each year over a period of 4 years. No performance or market conditions exist.<br><br>In the event of a sale of Company F, vested profits interests are contractually required to be settled through cash distribution. Also in the event of a sale, participants holding unvested profits interests will forfeit those interests. |
| **Distribution/ liquidation rights** | Class A preferred units have a 12% preferred priority return, which is cumulative and compounds quarterly. Distributions of available | Class A preferred units have an 8% preferred priority return, which is cumulative and compounds quarterly. Distributions of available |

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| | cash are to be made at the Board of Directors' discretion in the following order:<br><br>• First to pay the accumulated 12% preferred priority return;<br>• Second to pay any unpaid Class A preferred unit capital contributions (i.e. the original investment in exchange for Class A preferred units);<br>• Third to pay any unpaid capital contributions related to the Class A common units and Class B common units (i.e. the original investment in exchange for Class A common units and Class B common units);<br>• Fourth to the common unit holders (Class A, B and C), pro rata; provided that a holder of a vested Class C common unit shall not be entitled to any distributions unless and until a hurdle amount on all distributions is met. This hurdle amount is estimated to be $40.0 million, meaning that no Class C common unit holders would receive distributions until the full amount used to capitalize Company E is repaid.<br><br>Distributions upon liquidation would follow the same protocol as above.<br><br>Further, Class C common unit holders are eligible to receive tax allocations, and receive Form K-1 for their portion of income allocation, as with all other members of Company E. However, all K-1s issued for Class C to date have zero value. | cash are to be made at the Board of Directors' discretion in the following order:<br><br>• First to pay the accumulated 8% preferred priority return;<br>• Second to pay any unpaid Class A preferred unit capital contributions (i.e. the original investment in exchange for Class A preferred units);<br>• Third, pro rata to the profits interest holders based on relative percentage interest held.<br><br>Distributions upon liquidation would follow the same protocol as above.<br><br>While distributions can be made prior to an exit transaction, management believes this is unlikely based on the company's current value and the required preferred return. Instead, management expects that all outstanding Class A profits interest units would only benefit the holders through cash settlement upon an exit transaction.<br><br>Further, Class A profits interest holders are eligible to receive tax allocations, and receive Form K-1 for their portion of income allocation, as with all other members of Company F. However, all K-1s issued to date have zero value. |





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|---|---|---|
| **Pre-emptive rights** | While the Class C unit holders are not entitled to the same preemptive rights[2] as other unit holders, all members regardless of which unit type, are able to participate in drag-along rights[3] or tag-along rights[4]. | All holders, including profits interest holders, participate in tag-along and drag-along rights. |
| **Retention of interests upon termination of employment, and/or repurchase features** | Upon termination without cause, Class C common units held by an employee are subject to a call provision whereby Company E could elect to repurchase the units at fair market value. This is deemed a contingent call feature at fair market value. The company has no history or intent of exercising this call feature. | Upon termination for any reason, vested interests are subject to a repurchase option by Company F. If the repurchase option is not elected by the Company, the employee retains only vested profits interests after termination. Employees cannot require the Company to repurchase the awards (i.e., the repurchase feature is within the control of the company upon employee termination). Unvested profits interests are forfeited as of termination date. Company F has a history of exercising the repurchase feature upon termination and further expects to continue repurchasing, at an amount that is below fair market value. |
| **Existence of separate cash bonus program?** | No. The intent of the award is to use the profit interest in lieu of a cash performance bonus because it is tied to future performance of the company. | Company F has a discretionary bonus plan as determined annually by the compensation committee. The profits interests are akin to an additional bonus upon a sale of the Company. |
| **Survival of profits interests after a change in control?** | There is no explicit provision requiring settlement of the profits interests upon a change in control event. That is, the Class C units are not precluded from continuing to exist or from being replaced by a similar class of equity subsequent to a change in control transaction. | No. The operating agreement states that in the event of a sale of Company F in which cash proceeds are not sufficient to cover distributions to profits interest holders, such profits interest shall automatically be forfeited and the participants holding such profits interest shall no longer have any rights with respect to such interests. |

[2] Current unit holders' rights to maintain their fractional ownership of the company by purchasing a proportional number of units of any future issuance.
[3] A right that grants the controlling unit holders the option to compel unit holders subject to the drag-along provision to sell their units in a transaction in which the controlling unit holders transfer control of the company.
[4] A right that grants unit holders the option to participate in a sale of units by the controlling unit holders.





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| **Application of Outcome A** | Under Outcome A, the profits interests would be treated as deferred compensation subject to Topic 710. Factors supporting this conclusion:<br>• While profits interest holders are entitled to interim distributions as determined by the Board of Directors, or liquidating distributions upon sale of the company, management does not believe that the Class C common unit holders would benefit from such distribution unless the company were to be recapitalized or sold. The reason for this is based on the waterfall payment provisions above and the significant subordination of the Class C common units. At the date of the analysis, the 12% cumulative preferred priority return called for by the Class A preferred units has not been paid, and is not expected to be paid in the near term based on expected cash flows generated by the company.<br>• The recipients are not eligible for a separate cash bonus program. That is, the profits interest is used in lieu of a cash bonus program.<br>• The units are relatively subordinate to other classes and distributions appear unlikely except upon the occurrence of a liquidity event. | Under Outcome A, the profits interests would be treated as deferred compensation subject to Topic 710. Factors supporting this conclusion:<br>• The lack of survival upon a sale of the company and the below-market repurchase (call) feature.<br>• The lack of voting rights, lack of transferability, and relatively low likelihood of distributions prior to a change in control. |
| **Application of Outcome B** | Under Outcome B, the awards would be treated as stock compensation subject to Topic 718. Factors supporting this conclusion:<br>• Legal form of the security is equity.<br>• Repurchase feature in connection with termination is at fair value.<br>• Distributions are proportionate to ownership (albeit subject to a distribution threshold).<br>• Award could survive a change in control. | Under Outcome B, the awards would be treated as stock compensation subject to Topic 718. Factors supporting this conclusion:<br>• Legal form of the security is equity.<br>• Distributions are proportionate to ownership (albeit unlikely to occur given the company's current economic situation).<br>• Award is eligible to participate in the profits of the partnership (i.e., K-1 allocations).<br>• Certain drag-along and tag-along rights exist. |





| | | |
|---|---|---|
| | • Award is eligible to participate in the profits of the partnership (i.e., K-1 allocations).<br>• Certain drag-along and tag-along rights exist.<br>• Some would note the presence of a market condition (in this case, upon attaining a certain threshold of equity value in a change in control, vesting of all units will be accelerated) requires application of ASC 718 because the market condition is based, at least in part, on the price of the entity's shares or other equity instruments, thus meeting the scope criteria in paragraph 718-10-15-3. | • Company offers a separate annual cash bonus program. |