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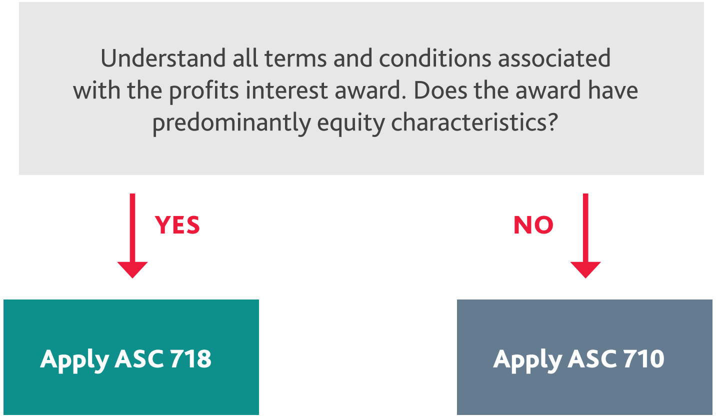
Profits Interests

INTRODUCTION

This Practice Aid provides accounting guidance on profits interests, a special class of equity primarily granted by a partnership or limited liability company (LLC) to its employees. The purpose of profits interest awards is generally 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. Profits interests have become a prevalent form of incentive compensation.

This practice aid summarizes the U.S. GAAP accounting framework for profits interests issued to employees.[1] The primary focus of the practice aid is to assist practitioners with determination of whether to account for a profits interest award under FASB Accounting Standards Codification ("ASC") 710[2] or ASC 718.[3]



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1 Awards issued to non-employees are outside the scope of this publication.
2 *Compensation-General*
3 *Compensation-Stock Compensation*

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PROFITS INTERESTS PRIMER

Partnerships and LLCs issue profits interests which are subject to specific, often favorable, tax regulations under the Internal Revenue Code.[4] Generally, a company's operating agreement defines all classes of legal equity that the company is authorized to issue, including the profits interest class. Also, the operating agreement usually describes relevant features associated with each class of equity, including voting rights, pre-emptive[5] and related rights, distribution and liquidation rights, repurchase features, and other relevant terms and provisions. Awards that qualify as profits interests are often described in legal agreements as "class X units," where "X" refers to the class of equity, or they may be referred to as "management units" or "incentive units."

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. 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 change of control) or final liquidation of the entity (collectively, hereafter referred to as "exit event").
- Profits interests may be moderately to highly subordinate to other classes of securities or interests in the entity, and as a result, may have a relatively high distribution hurdle. Recipients of such profits interests generally will not receive 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 an exit event.
- Profits interests frequently have an explicit performance condition linked to an exit event.
- Profits interests may or may not have an explicit service condition required for vesting.
- Forfeiture provisions vary. Some profits interests 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. Those call options may relate to vested and/or unvested portions of the profits interests.

APPLICABLE ACCOUNTING GUIDANCE AND CURRENT PRACTICE

An entity begins by assessing the features of the profits interest award and determining the appropriate accounting model, ASC 710 or ASC 718. The scope of ASC 710-10 includes performance bonus, profit sharing, and specific deferred compensation contracts,[6] but excludes stock compensation plans.[7] Stock compensation plans are specifically addressed by ASC 718 (or ASC 505-50[8] if issued to non-employees). Since U.S. GAAP does not provide explicit guidance on how to account for profits interests, entities with profits interests evaluate all of the terms, conditions, and characteristics of such awards and apply judgment to determine whether the awards are subject to ASC 718 or ASC 710.

4 The Internal Revenue Service defines the following types of interests in a partnership:
1. Capital interest - an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership. This determination generally is made at the time of receipt of the partnership interest.
2. Profits interest - a partnership interest other than a capital interest.
Refer to IRS Rev. Proc. 93-27, 1993-2 CB 343, 06/09/1993, IRC Sec(s). 721

5 Current unit holders' rights to maintain their fractional ownership of the company by purchasing a proportional number of units of any future issuance.

6 ASC 710-10-15-3 and 15-4

7 ASC 710-10-15-5e

8 *Equity-Based Payments to Non-Employees.* ASU 2018-07 supersedes ASC 505-50 by expanding the scope of ASC 718 to include nonemployee awards and generally aligning the accounting for nonemployee awards with the accounting for employee awards (with limited exceptions). The effective date for public companies is for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. For all other entities, the effective date is fiscal years beginning after December 15, 2019. See our **BDO Alert** for more information.

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

	Performance Bonus ASC 710 Accounting Model	Stock Compensation ASC 718 Accounting Model
Recognition	Recognized when payment is both probable and reasonably estimable. Compensation cost may or may not be spread over multiple accounting periods	Generally recognized as employee services are rendered either on a straight-line basis or graded attribution basis
Measurement	Present value and then remeasured at each reporting date	Fair value (FV): ▶ Grant date for equity-classified awards; no remeasurement unless a modification or reclassification occurs ▶ Settlement date (i.e. remeasure FV at each reporting date through settlement) for liability-classified awards
Classification	Liability	Provides a framework for evaluating whether an award should be classified as equity or as a liability
Presentation of distributions to holders	Cash distributions to holders represent compensation cost	Distributions to holders (in cash or additional shares) are treated as capital transactions (e.g., dividends) and generally do not result in additional compensation cost, absent a modification, reclassification, or settlement

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The SEC staff has addressed the scoping issue related to profits interests, indicating:

> 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.[9]

As a result of the "facts and circumstances" approach described by the SEC staff, there is currently diversity in practice in how entities account for profits interests, either under ASC 718 or ASC 710.

9 See speech by Joseph Ucuzoglu, Professional Accounting Fellow, at the December 2006 AICPA National Conference on Current SEC and PCAOB Developments.

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PRACTICAL STEPS TO ASSESS ACCOUNTING FOR PROFITS INTERESTS

The following steps provide a framework for assessing how to account for profits interests. Companies must evaluate all the relevant provisions of profits interests and related agreements to determine the substance of the compensation arrangement for accounting purposes. The following steps can be applied as a reasonable approach in reaching these judgments:

Step 1: Understand the terms and conditions associated with the profits interest. This generally includes reading the partnership and/or operating agreement(s), incentive plan document, executed award documents and employment contracts, and any amendments to the aforementioned agreements. This also includes understanding the organizational structure of the employer and its related parties; profits interests are sometimes issued by a parent company or other investor to employees of a subsidiary or investee, and the organizational relationships can impact the accounting for the profits interest. Further, although not determinative, an understanding of the income tax treatment of the profits interest can be informative to the assessment.

Step 2: Determine whether ASC 710 or ASC 718 applies. Based on an understanding of the terms and conditions obtained in step 1, assess whether the award is more akin i) to a profit-sharing or deferred bonus arrangement (subject to ASC 710), or ii) to an equity-based compensation arrangement (subject to ASC 718). Refer to the Key Indicators and Other Indicators tables below for factors to consider in the assessment. All indicators must be considered and weighed together (i.e. generally no one factor is determinative). However, we believe in most instances it is appropriate to place more weight on the key indicators, and less weight on the other indicators. In some instances, other guidance may apply. A complete understanding of the organizational structure of the entity and its related parties is important to this analysis.[10]

Step 3: For profits interests accounted for under ASC 718, assess cost attribution period and equity or liability classification. Even if a profits interest award has been determined to be in the scope of ASC 718, it may still need to be classified as a liability. Apply the guidance in ASC 718-10-25-6 through 25-19 to determine classification. Further, compensation cost for share-based payments should be recognized according to the specific guidelines in ASC 718. This is generally based on the requisite service period.

Step 4: Assess which entity(ies) should recognize compensation cost. Compensation arrangements awarded to an employee of a reporting entity by a related party or other holder of an economic interest in the entity as compensation for services provided to the reporting entity should be reflected as compensation by the reporting entity unless the transfer is clearly for a purpose other than compensation for services to the entity. For example, a parent company may issue an award of its own equity to the employee of a wholly-owned subsidiary. The substance of such a transaction is that the economic interest holder makes a capital contribution to the reporting entity, and that entity makes a compensation payment (share-based or other) to its employee in exchange for services rendered. This concept applies regardless of whether the awards are in the scope of ASC 710 or ASC 718.

The approach described above is depicted in the flowchart in Appendix A.

10 An award may not be subject to ASC 710 or ASC 718. For example, an award meeting the definition of a derivative instrument, such as a stock option with underlying shares indexed to the shares of another company, would be subject to guidance in ASC 815.

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Key Indicators to assess the appropriate accounting model

	ASC 718 Indicators	ASC 710 Indicators
Value of the Award	The value of the award to the recipient is based, at least in part, on the value of the entity's equity. BDO views this as the strongest indicator, based on ASC 718-10-15-3.	The value of the award to the recipient is based primarily on a fixed value or one derived from a formula.[11] Refer to Example A for an illustration of this indicator.
Settlement features	Vested awards may survive a change in control, liquidity, or other exit event. Refer to Example B for an illustration of this indicator.	Vested awards are contractually required to be settled or terminated upon an exit event.[12]
Distribution rights	Distributions to holders may occur prior to an exit event, even if subject to a distribution threshold, and are based upon each holder's pro rata share of ownership.	Distributions to holders are contractually or legally limited to an exit event, and/or distributions are not made on a pro rata basis.[13]
Separate cash bonus plan	Company offers a separate cash bonus program, and profits interest holders are eligible to participate.	Profits interests are issued in lieu of a cash bonus program.
Retention of interests upon termination of employment, and/or repurchase features	Employees may retain vested awards upon termination. The employer may have the option, but not an obligation, to repurchase vested units at fair value upon employee termination.	Vested awards are automatically forfeited or repurchased upon employee termination, either at fair value or some other amount.

11 Profits interests typically include a threshold which must be attained before profits interest holders can receive distributions. This may be referred to with terms such as "hurdle" or "waterfall." Such a threshold generally does not indicate the award value is formula-based.

12 Companies may assert an intention or expectation of settlement upon an exit event, despite the contractual terms allowing for negotiation. In such situations, we believe the likelihood of settlement is not relevant. Rather, companies should look to the contractual and legal terms of whether settlement for cash or other assets is required.

13 Companies may assert that a distribution is highly unlikely to be made until an exit event given a significant hurdle threshold to overcome. This assertion is made despite the fact that distributions can contractually and legally be made at the Board's discretion at any time. In such situations, we believe the likelihood of distributions is not relevant. Rather, companies should look to the contractual and legal terms of when distributions can occur.

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Other Indicators

	ASC 718 Indicators	ASC 710 Indicators
Legal form of instrument	Legal form is equity. Note that profits interests subject to IRS Rev. Proc. 93-27 are, by definition, legal equity.	Because profits interests are, by definition, legal equity, this indicator is generally neutral. Other indicators will be given more weight.
Voting rights	Holders have voting rights commensurate with other equity classes and on a pro rata ownership basis.	Holders do not have voting rights, or disproportionate voting rights.
Transferability	Interest is transferrable upon vesting. Note that in closely-held private companies, it is common for a share to have restrictions on transferability or for a transfer to be precluded, so this is generally not determinative.	Interest is not transferrable.
Pre-emptive, tag-along, or drag-along rights	Awards may contain pre-emptive rights, tag-along rights,[14] drag-along rights, [15] or antidilution provisions.	Awards do not contain such features.
Initial investment required	Awards may require initial investment. Note that it is common for share-based payment awards not to require an initial investment, so this may not be determinative.	Awards do not require initial investment.
Management's intent	Management's intent behind issuing the awards is to provide holders with an equity interest in the company.	Management's intent behind issuing the awards is to provide employees with an incentive bonus upon an exit event. Note that often such awards are structured as profits interests for tax planning purposes.

14 A right that grants holders the option to participate in a sale of units by the controlling holders.

15 A right that grants the controlling holders the option to compel holders subject to the drag-along provision to sell their shares in a transaction in which the controlling holders transfer control of the company.

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ILLUSTRATIVE EXAMPLES

EXAMPLE A

ABC LLC (the "Company") issues profits interests to key employees that vest over 4 years of continuous service. No performance or market conditions exist, and no initial investment is required. Additional key terms are as follows:

- Upon an exit event, vested profits interests are contractually required to be settled through cash distribution based on a predetermined formula. The formula includes operating metrics, but does not include the fair value of the company's equity. Also in an exit event, participants holding unvested profits interests will forfeit those interests for no value.
- All holders, including profits interest holders, have preemptive, tag-along and drag-along rights (other than in a change in control).
- Upon termination for any reason, vested interests are subject to a repurchase option by the Company at the lower of initial investment (i.e., $0 because no investment was required of the holder to obtain the profits interests) or fair value. 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. The Company has a history of exercising the repurchase feature upon termination and further expects to continue repurchasing.
- Distributions may be made at the board's discretion, and are made first based on a preferred priority return to holders of senior stock, then on a pro rata basis to all holders (including holders of vested profits interests) based on relative percentage interest held. However, management believes there is a very low probability that any distributions will occur prior to an exit event.
- Profits interests, both vested and unvested, may not be transferred without express consent of the board, and holders have no voting rights.
- ABC LLC has a discretionary bonus plan as determined annually by the compensation committee in which profits interest holders participate.
- Management's intent in issuing profits interests is to provide an additional bonus upon an exit event.

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Example A Indicators

	ASC 718 Indicators	ASC 710 Indicators
Value of the Award		When an exit event occurs, vested profits interests are settled in cash based upon a predetermined formula driven by operating metrics.
Settlement features		Vested awards are contractually required to be settled upon an exit event.
Distribution rights	Distributions to holders may occur prior to an exit event and are based upon each holder's pro rata share of ownership, but are unlikely.	
Separate cash bonus plan	Company offers a separate cash bonus program, and profits interest holders are eligible to participate.	
Retention of interests upon termination of employment, and/or repurchase features	Employees may retain vested awards upon termination.	In practice, vested awards are repurchased upon employee termination, at the lower of initial investment or fair value.
Legal form of instrument	Legal form of profits interest is equity.	Because profits interests are, by definition, legal equity, this indicator is generally neutral. Other indicators will be given more weight.
Voting rights		Holders do not have voting rights.
Transferability		Interest is not transferrable.
Pre-emptive, tag-along, or drag-along rights	Awards contain pre-emptive rights, tag-along rights, and drag-along rights.	
Initial investment required		Awards do not require initial investment.
Management's intent		Management's intent behind issuing the awards is to provide employees with an incentive bonus upon an exit event.

Management assesses these provisions in light of the indicators above, and concludes that the terms and conditions of the award are more akin to a profit-sharing arrangement or a performance bonus, subject to ASC 710. This conclusion is based primarily on (i) value of the award is derived from a predetermined formula (ii) lack of survival of vested awards upon an exit event, and (iii) below-market repurchase (call) feature which the company has a history of exercising. This conclusion is also supported by other ASC 710 indicators noted in the tables above.

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EXAMPLE B

XYZ LLC (the "Company") issues management incentive units that are deemed profits interests to key employees that vest at the end of each year over a period of 5 years based on achievement of specific earnings targets, subject to the recipient remaining in continuous employment. The earnings target is deemed a performance condition. No initial investment is required. Additional key terms are as follows:

- Upon an exit event, vesting of all units will be accelerated subject to attaining a certain threshold of equity value from the event. This is deemed a combined performance and market condition.
- Because the contractual agreements are silent as to settlement upon an exit event, the units would be subject to negotiation and potential replacement upon an exit event (i.e., they are eligible to survive a change in control).
- While the profits interest holders are not entitled to the same preemptive rights as other unit holders, profits interest holders are able to participate in drag-along and tag-along rights.
- Upon termination for any reason, vested interests are subject to a repurchase option by the Company at fair value. 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. The Company has no history of exercising the repurchase option, and has not decided whether it would exercise the option in the future.
- Distributions may be made at the board's discretion, and are made first based on a preferred priority return to holders of senior stock, then on a pro rata basis to all unitholders (including holders of vested profits interests) based on relative percentage interest held. However, management believes there is a very low probability that any distributions will occur prior to an exit event.
- Profits interests, both vested and unvested, may not be transferred without express consent of the board, and holders have no voting rights.
- XYZ LLC offers a separate cash bonus program annually based on performance of the Company and the individual, and profits interest holders are eligible for such cash bonuses.
- Management's intent in issuing profits interests is to provide an equity ownership to key employees of the Company.

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Example B Indicators

	ASC 718 Indicators	ASC 710 Indicators
Value of the Award	Upon an exit event, vesting of all units will be accelerated subject to attaining a certain threshold of equity value from the event (includes a market condition).	
Settlement features	Vested awards can survive a change in control, liquidity, or other exit event.	
Distribution rights	Distributions to holders may occur prior to an exit event and are made first based on a preferred priority return to holders of senior stock, then on each holder's pro rata share of ownership. However, there is a lower probability of distributions before an exit event.	
Separate cash bonus plan	Company offers a separate cash bonus program, and profits interest holders are eligible to participate.	
Retention of interests upon termination of employment, and/or repurchase features	Employees can retain vested awards upon termination if not repurchased by the Company. Vested awards are subject to repurchase upon employee termination at fair value. The Company has no history of repurchasing the vested awards.	
Legal form of instrument	Legal form of profits interest is equity.	Because profits interests are, by definition, legal equity, this indicator is generally neutral. Other indicators will be given more weight.
Voting rights		Holders do not have voting rights.
Transferability		Interest is not transferrable.
Pre-emptive, tag-along, or drag-along rights	Awards have tag-along rights and drag-along rights.	
Initial investment required		Awards do not require initial investment.
Management's intent	Management's intent behind issuing the awards is to provide key employees with equity ownership.	

Management assesses these provisions in light of the indicators above, and concludes that the terms and conditions of the award are more akin to a share-based compensation arrangement, subject to ASC 718. This conclusion is based primarily on the awards' (i) value of the award is derived from the fair value of company equity (ii) potential to survive an exit event or change in control and (iii) repurchase (call) feature at fair value which the company has no history of exercising. This conclusion is also supported by the ASC 718 indicators noted in the tables above. Management would next assess whether the awards are equity- or liability-classified according to the framework provided in ASC 718-10-25-6 through 25-19.

BDO Observation: Weighting of Indicators
As demonstrated through the examples above, most awards will have characteristics of both deferred compensation and stock compensation awards. Practitioners must consider all of the indicators holistically and weight them appropriately. This may require significant judgment. Generally, no one indicator on its own will be determinative.

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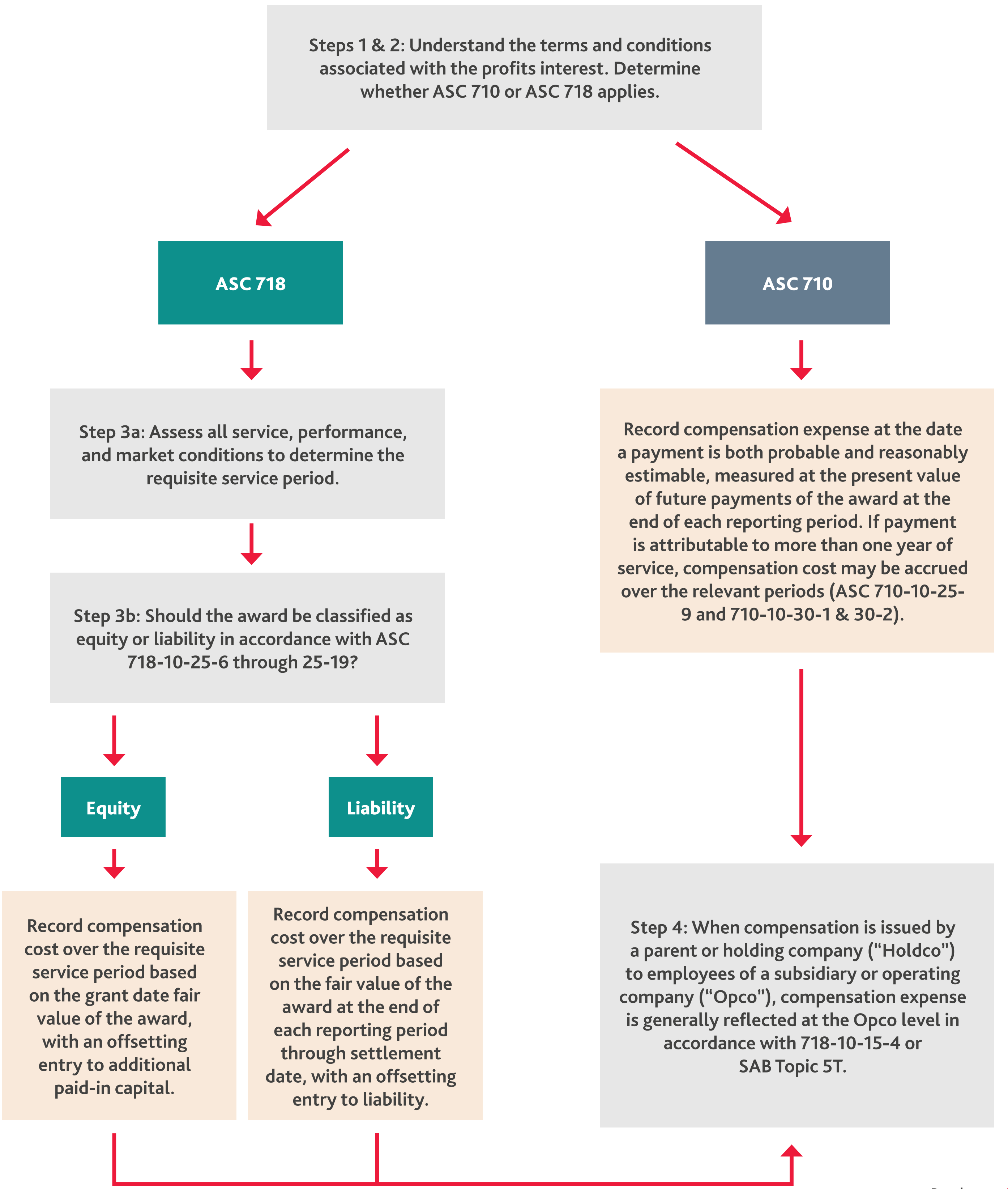
APPENDIX A – ASC 710 OR ASC 718 FLOWCHART



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