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File Reference No. 2023-ED300
Financial Accounting Standards Board
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Proposed Accounting Standards Update, *Compensation — Stock Compensation (Topic 718): Scope Application of Profits Interest Awards*
(File Reference No. 2023-ED300)

Dear Ms. Salo:

We appreciate the opportunity to comment on the Proposed Accounting Standards Update, *Compensation — Stock Compensation (Topic 718): Scope Application of Profits Interest Awards*, issued by the Financial Accounting Standards Board (FASB or Board).

We support the Board's intent to clarify how an entity would apply the scope guidance to determine whether profits interests and similar awards should be accounted for in accordance with Accounting Standards Codification (ASC) 718 or another accounting standard. As discussed below, we believe the proposed amendments could be enhanced to provide further clarification for stakeholders to understand the Board's intent on specific matters.

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We would be pleased to discuss our comments with the FASB or its staff at your convenience.

Very truly yours,

Ernst & Young LLP

Appendix — Responses to questions raised in the Proposed Accounting Standards Update, *Compensation — Stock Compensation (Topic 718): Scope Application of Profits Interest Awards*

> **Question 1:** Do you agree that the amendments in this proposed Update should apply to all reporting entities (including PBEs and entities other than PBEs)?
>
> Please explain why or why not.

We agree that the proposed amendments should apply to all reporting entities. While traditional profits interest awards are common among privately held entities, public business entities (PBEs) issue profits interests and similar awards. We do not believe it would be beneficial to establish differences between PBEs and other entities in this area.

> **Question 2:** Is the proposed illustrative example included in paragraphs 718-10-55-138 through 55-148 to determine whether a profits interest award should be accounted for in accordance with Topic 718 clear and operable? Please explain why or why not. Should the illustrative example include other considerations or exclude any considerations? If yes, please explain how you would change the proposed illustrative example.

Board intent

We understand that the purpose of the proposal is to provide an illustrative example on when a profits interest award would clearly be in the scope of 718 and when it wouldn't (i.e., "bookend" fact patterns of profits interests). We believe it would be helpful for the FASB to emphasize that judgment will be necessary to evaluate profits interest arrangements with terms that differ from the bookend fact patterns provided in the example. We believe this could be best accomplished by expanding the discussion in paragraph BC19 in the Background Information and Basis for Conclusions about the Board's intent with the proposal. We do not believe that it is necessary to provide more examples because it may result in confusion in practice.

We believe that the Board should clarify the following matters to make sure the proposed illustrative example is clear and operable.

Definition of 'vested' in ASC 718

In the proposal, paragraph BC18 states that the proposed illustrative example highlights key considerations to help an entity determine how to evaluate common terms and characteristics of profits interests and similar awards, including a grantee's forfeiture of an award that, upon termination of employment with the entity, has vested according to the contract but that does not meet the definition of vested in ASC 718.

Although this paragraph implies that the proposed amendments contain guidance on how to evaluate awards that have vested according to the contract but do not meet the definition of vesting in ASC 718, we do not believe that the proposed amendments are clear on this point.

We note that the award in Case C allows the grantee to participate in operating distributions after three years of service, but the award is forfeited upon termination at any time. In paragraph 718-10-55-146, the conclusion that the award does not meet the scope criteria in ASC 718 is supported by the fact that the proceeds are not based on the price of the entity's shares and the entity is not required to issue shares. However, Case C does not address how an entity would consider the "inability to vest" in accordance with the definition in ASC 718 when assessing whether an award should be accounted for under ASC 718.

For example, consider a profits interest award that vests after one year of service. However, upon termination of the employee at any time, the entity is entitled to repurchase the profits interest for no consideration (i.e., the profits interest is forfeited). Under the terms of the award, the grantee participates in distributions and the proceeds from a liquidity event only during employment. Therefore, the award has vested according to the contract after one year (and units are legally issued), but the award does not meet the definition of vested in accordance with ASC 718.

We have observed diversity in practice in accounting for similar awards today. Some conclude that the award is accounted for under ASC 710 because the award is considered to be in substance a profit-sharing arrangement. Others conclude that the award is accounted for under ASC 718 and that it has an implied performance condition (although a liquidity event is not explicitly stated as a vesting condition, a liquidity event is required for the award to vest). Further, others conclude that the award should be bifurcated into two components: (1) the distributions paid during employment (accounted for as a profit-sharing arrangement under ASC 710) and (2) participation in the proceeds upon a liquidity event during employment (accounted for under ASC 718 as an arrangement with an implied performance condition).

Since the FASB notes that this is a common term (paragraph BC18), we recommend the Board consider further clarifying how to evaluate such a provision if the Board does not believe that there should be diversity in practice.

Exposure to changes in fair value

Case A concludes that the awards would be subject to the guidance in ASC 718. Paragraph 718-10-50-141(a) specifies that the condition in paragraph 718-10-15-3(a) is met because the grantee can retain the vested Class B units upon termination of service, subject to repurchase by Entity X at fair value on the call date and, therefore, is exposed to the changes in the fair value of Entity X's equity.

We believe the reference to a grantee being exposed to changes in the fair value of Entity X's equity could cause confusion and may inappropriately imply that an award should not be accounted for under ASC 718 if a grantee is not exposed to changes in fair value during the life of the award. This factor is considered when assessing whether an award that has been determined to be in the scope of ASC 718 should be classified as a liability or as equity. However, the continued exposure to changes in the fair value of the entity is not a consideration in the scoping criteria set forth in paragraph 718-10-15-3(a), and therefore, we recommend that this reference be removed.

Application of proposal to awards to employees and nonemployees

In the section titled "Who Would Be Affected by the Amendments in This Proposed Update?" the proposal states that the amendments would apply to all reporting entities that account for profits interest awards "as compensation to employees in return for goods or services." In addition, paragraph BC13 states that the proposed amendments would apply to all reporting entities that account for profits interest awards "as compensation to employees in return for goods or services." Because ASC 718 applies to awards granted to both employees and nonemployees, we believe these references should be updated to state that the proposed amendments apply to all reporting entities that "grant profits interest awards to employees or nonemployees in exchange for goods or services" to align with the language in paragraph 718-10-15-3.

> **Question 3:** An entity would be required to apply the proposed amendments either (a) retrospectively to all prior periods presented in the financial statements or (b) prospectively to awards granted or modified on or after the effective date with an associated disclosure that describes the nature of and reason for the change in accounting principle. Do you agree with the proposed transition provisions? If not, why not, and what basis would be more appropriate and why?

We agree with the option to apply the proposed amendments either retrospectively to all periods presented in the financial statements or prospectively to awards granted or modified on or after the effective date. Additionally, we recommend that the Board clarify that if retrospective adoption is elected, the entity would provide the disclosures required in paragraphs 250-10-50-1 through 50-3 in the period of adoption.

> **Question 4:** Regarding the effective date, how much time would be needed to implement the proposed amendments? Should the amount of time needed to implement the proposed amendments by entities other than PBEs be different from the amount of time needed by PBEs? Should early adoption be permitted? Please explain your response.

We defer to preparers about how much time would be needed to implement the proposed amendments.

We believe early adoption should be permitted.