Tel: 214-969-7007
Fax: 214-953-0722
www.bdo.com

600 North Pearl, Suite 1700
Dallas, TX 75201

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

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. 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. 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

	cash are to be made at the Board of Directors' discretion in the following order: • First to pay the accumulated 12% preferred priority return; • Second to pay any unpaid Class A preferred unit capital contributions (i.e. the original investment in exchange for Class A preferred units); • 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); • 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. Distributions upon liquidation would follow the same protocol as above. 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: • First to pay the accumulated 8% preferred priority return; • Second to pay any unpaid Class A preferred unit capital contributions (i.e. the original investment in exchange for Class A preferred units); • Third, pro rata to the profits interest holders based on relative percentage interest held. Distributions upon liquidation would follow the same protocol as above. 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. 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.

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.

Application of Outcome A	Under Outcome A, the profits interests would be treated as deferred compensation subject to Topic 710. Factors supporting this conclusion: • 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. • 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. • 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: • The lack of survival upon a sale of the company and the below-market repurchase (call) feature. • 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: • Legal form of the security is equity. • Repurchase feature in connection with termination is at fair value. • Distributions are proportionate to ownership (albeit subject to a distribution threshold). • 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: • Legal form of the security is equity. • Distributions are proportionate to ownership (albeit unlikely to occur given the company's current economic situation). • Award is eligible to participate in the profits of the partnership (i.e., K-1 allocations). • Certain drag-along and tag-along rights exist.

	• Award is eligible to participate in the profits of the partnership (i.e., K-1 allocations). • Certain drag-along and tag-along rights exist. • 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.