Private Company Council Meeting

Public Meeting

June 22, 2021

The views expressed in this presentation are those of the presenter.
Official positions of the FASB are reached only after extensive due process and deliberations

FASB

Profits Interests and Their Interrelationship with Partnership Accounting

Jenifer Wyss, Supervising Project Manager
Chris Bohdan, Assistant Project Manager
Preston Lewis, Postgraduate Technical Assistant
Lauren Reno, Postgraduate Technical Assistant
Jeff Mechanick, Assistant Director

Overview

The staff and Working Group are working together to conduct outreach on profits interests issues.

During the June 25, 2020 meeting, PCC members shared their experiences with profits interests and provided questions and comments on the staff's research.

Since that time, the staff and Working Group have performed outreach with valuation and legal/tax specialists and have reported out to the PCC.

The staff and Working Group will be conducting outreach with preparers, practitioners, and users to identify accounting issues that may need to be addressed through standard setting.

Presentation Roadmap

This presentation is divided into **two** sections:

1. **Discussion of PCC members' experiences with profits interests in practice**

2. **Profits Interests Example (if time allows)**
   - Profits interests granted for private company, remain outstanding for entity after IPO.

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Section 1—Questions for PCC Members

Experience with profits interests in practice

Questions for PCC Members

Can you **describe your experience with profits interests awards**, if applicable?

- What types of entities (industry, ownership, etc.) granted the profits interests?
- Who were the recipients/grantees?
- How material were any recognized expenses related to profits interests in the entity's financial statements?

Were any **accounting challenges faced**? If so, what were they?

How is the **appropriate scope of guidance** of profits interests awards being determined in practice? (Topic 718, Topic 710, or other)

Do you have other experiences/points of view related to profits interests or partnership accounting that you would like to highlight?

When analyzing a company's financial performance, how does your analysis of profits interests expenses compare to your analysis of expenses from other equity awards (options, RSUs, etc.)?

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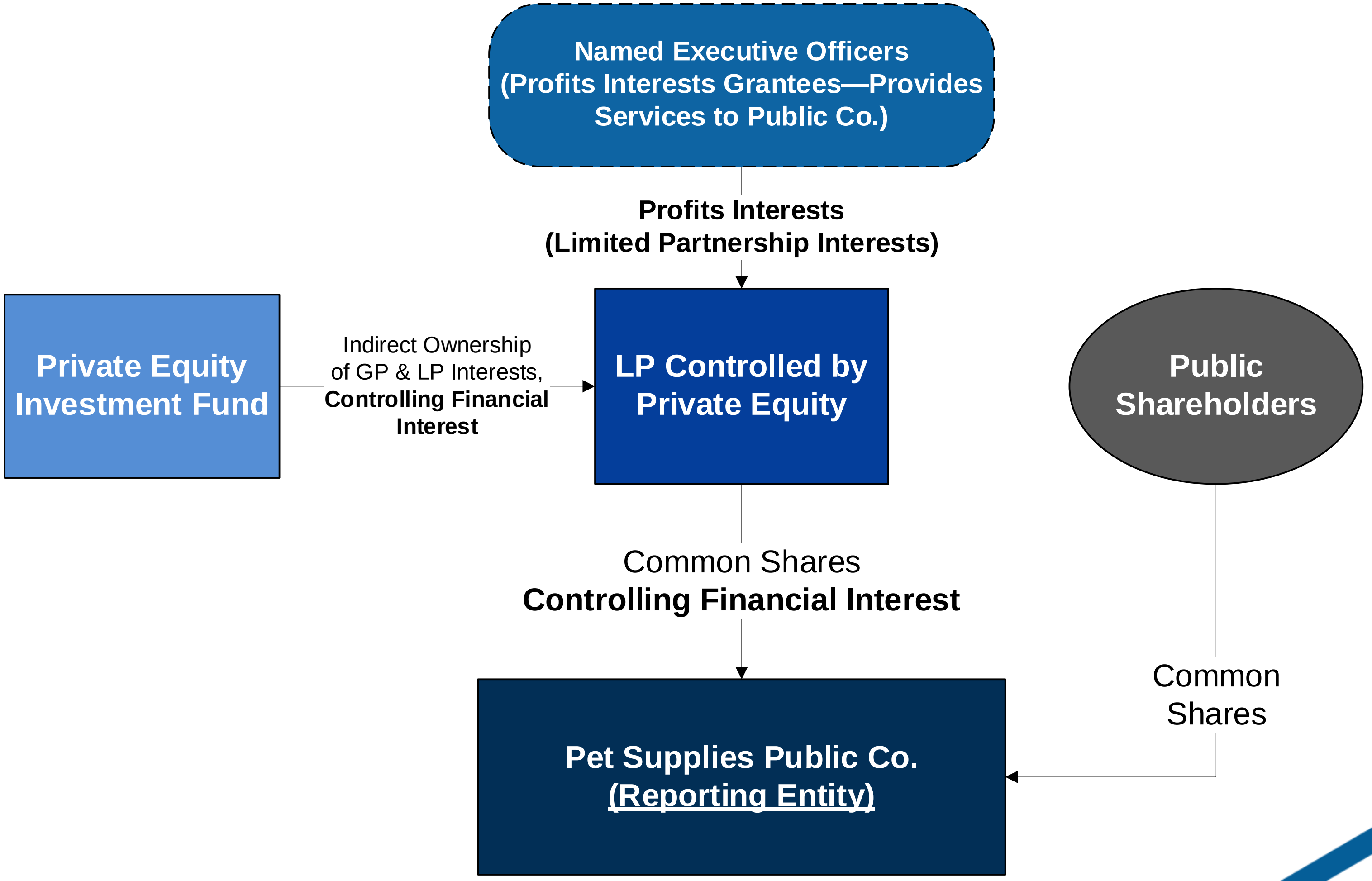
Section 2—Profits Interests Example

Simplified Example—Pet Supplies Public Co.



Simplified Example—Pet Supplies Public Co., continued

- Profits Interests were **granted before the IPO and remained outstanding after the IPO** as interests in the LP controlled by Private Equity.
  - *The Profits Interest Units are intended to qualify as "profits interests" for U.S. tax purposes. They do not require the payment of an exercise price but are economically similar to stock appreciation rights because they have no value for tax purposes as of the grant date and will obtain value only as the value of the underlying security rises above its distribution threshold.*
- The same private equity investment fund **continued to control Public Co. post-IPO** (i.e., the Private Equity firm retained a controlling interest in the entity).
- **Public Co. directly receives services from the grantees** (the named executive officers) and therefore recognizes share-based compensation cost associated with the profits interests, although they are granted by LP controlled by Private Equity. See Excerpt from annual report below (edited for clarity):

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Simplified Example—Pet Supplies Public Co., continued

- **Key Guidance** (why the Public Co. recognizes compensation cost):
  - **718-10-15-4** Share-based payments **awarded to a grantee by a related party or other holder of an economic interest in the entity** as compensation for goods or **services provided to the reporting entity** are share-based payment transactions to be accounted for under this Topic unless the transfer is clearly for a purpose other than compensation for goods or services to the reporting entity. […]
- Profits interests unrecognized compensation expense = $26 million
  - Expected to be recognized over a weighted-average period of 3 years.
- Last year, the entity:
  - Recorded a **net loss of ~$30 million**
  - Recognized **~$13 million of compensation cost related to share-based payments** (profits interests and awards granted by PublicCo.)

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Simplified Example—Pet Supplies Public Co., continued

- From Public Co, Note 13, Stockholders' Equity
  - Profits Interest Unit awards are restricted profit interests in LP controlled by Private Equity firm, subject to a **distribution threshold**.
  - Issued in the form of **time-based units that vest in three to five equal annual installments** following the grant date (fully-vested upon a change in control).
  - For the Profits Interests Units granted during fiscal 2020, 2019, and 2018, the weighted average fair value per unit was estimated to be $0.44, $0.25, and $0.35, respectively.

- The weighted average fair value per Profits Interest Unit was estimated at the grant date using the Black-Scholes option pricing model (see table for assumptions):

	Fiscal years ended		
	January 30, 2021 (52 weeks)	February 1, 2020 (52 weeks)	February 2, 2019 (52 weeks)
Dividend yield	0.0%	0.0%	0.0%
Expected volatility (1)	60.0 - 81.9%	60.0%	45.0% - 65.0%
Weighted average volatility (1)	81.1%	60.0%	58.5%
Risk-free interest rate (2)	0.1% - 1.3%	1.4% - 2.3%	2.5% - 3.0%
Expected term (3)	2.0 to 4.0 years	5.0 years	4.0 to 5.5 years

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Appendix A: Valuation Footnotes

	Fiscal years ended		
	January 30, 2021	February 1, 2020	February 2, 2019
	(52 weeks)	(52 weeks)	(52 weeks)
Dividend yield	0.0%	0.0%	0.0%
Expected volatility (1)	60.0 - 81.9%	60.0%	45.0% - 65.0%
Weighted average volatility (1)	81.1%	60.0%	58.5%
Risk-free interest rate (2)	0.1% - 1.3%	1.4% - 2.3%	2.5% - 3.0%
Expected term (3)	2.0 to 4.0 years	5.0 years	4.0 to 5.5 years

(1) The expected volatility was estimated based on the historical volatility of a select peer group of similar publicly traded companies for a term that was consistent with the expected term of the Profits Interests Units.

(2) The risk-free interest rates were based on the U.S. Treasury constant maturity interest rate whose term was consistent with the expected term of the Profits Interests Units.

(3) The expected term of the Profits Interests Units was based on estimated liquidity event timing.

PCC Issue No. 2018-01, Practical Expedient to Measure Grant-Date Fair Value of Equity-Classified Share-Based Awards

James Starkey, Supervising Project Manager
Preston Lewis, Postgraduate Technical Assistant
Lauren Reno, Postgraduate Technical Assistant
Jeff Mechanick, Assistant Director

Current Issues in Financial Reporting

Led by PCC Members
with FASB input

Break—30 Minutes

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Improving the Accounting for Asset Acquisition and Business Combinations (Phase 3 of the Definition of a Business project)

Adriana Yepes, Supervising Project Manager
David Yates, FASB Practice Fellow
Chris Roberge, Senior Project Manager
Steven Whitman, Postgraduate Technical Assistant
Alicia Posta, Assistant Director

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Project Objective and Background

- Improve and align the accounting for acquisitions of businesses and assets
- Issues raised within the new revenue standard (Topic 606)
- Post-Implementation Review (PIR) of Statement 141(R), *Business Combinations*
- Addressed in 3 Phases:
  - Phase 1—Clarify the Definition of a Business (Update 2017-01)
  - Phase 2—Clarify the Scope of Subtopic 610-20 and Accounting for Partial Sales of Nonfinancial Assets (Update 2017-05)
  - **Phase 3—Reduce or eliminate differences between the accounting for asset acquisitions and business combinations**

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Contingent Consideration

- Contingent consideration often is used in acquisitions to:
  - Close the gap in expectations for the business between buyer and seller
  - Share risk associated with the future performance of the business/asset
- Contingent consideration in a business combination*
  - *Initial accounting*—recognized at fair value on acquisition date
  - *Subsequent accounting*—ongoing measurement at fair value, with changes reflected in earnings.

*Assumes the contingent consideration arrangement is not a derivative and is not equity-classified.

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Questions for PCC Members

Business Combinations:

1. What cost savings, if any, would be realized by removing the requirement for the acquirer to recognize the fair value of contingent consideration at the acquisition date?

2. How significant would the cost savings be if remeasurement was performed annually or based on a significant change in expectations (as opposed to each reporting period)?

3. If the acquirer was required to account for changes in the value of contingent consideration through an offset to purchase accounting (rather than through earnings), how would that affect the cost of accounting for contingent consideration?

Disclosures:

Users participating in staff outreach requested information about the expected timing and probability of contingent consideration payments, disaggregated by performance metric or milestone event.

4. Would that information be useful for private company users? If so, please explain how and why.

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Revenue—Post-Implementation Issues

Led by PCC Members with FASB input

Lucy Cheng, Project Manager
Steven Whitman, Postgraduate Technical Assistant
Mary Mazzella, Assistant Director

Private Company Council Topic 10—Public Meeting

Leases—Implementation Issues and Discount Rate for Lessees That Are Not Public Business Entities

Chris Roberge, Senior Project Manager
Bobbi Gwinn, Project Manager
Carolyn Warger, FASB Practice Fellow
Fungisai Chambwe, FASB Practice Fellow
Alyssa Mancini, Postgraduate Technical Assistant
Alicia Posta, Assistant Director

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Discount Rate for Lessees That Are Not Public Business Entities

- The Board added a project to the technical agenda to reconsider the risk-free discount rate accounting policy election for lessees that are not public business entities
- Tentative Decisions:
  1. Level of accounting policy election – *allow election by asset class*
  2. Discount rate specified in accounting policy election – *retain a risk-free rate*
  3. Interaction between the rate implicit in the lease and the accounting policy election – *require use of rate implicit in the lease when readily determinable*

April 2021
- Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities added to technical agenda

June 2021
- Planned Proposed ASU Issuance

August 2021
- Analyze feedback and begin redeliberations

3rd Quarter 2021/ 4th Quarter 2021
- Planned ASU issuance

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Weighted-Average Discount Rate Disclosure Questions

Current requirement

The **weighted-average discount rate** is disclosed separately for operating and finance leases, calculated based on:

- The discount rate
- Remaining balance of lease payments at reporting date

Alternative disclosure

Disclose the weighted-average discount rate separately for leases that use the risk-free rate and all other leases

- Would the alternative disclosure add cost and/or complexity to your leasing disclosures? Please explain.
- Would the alternative disclosure provide decision-useful information to users, relative to the current requirement? How would this information be used?

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CECL—Post-Implementation Review

Jay Shah, Supervising Project Manager
Marla Lewis, FASB Practice Fellow
Shannon Garavaglia, FASB Post-Doctoral Fellow
Scott Williams, Postgraduate Technical Assistant
Austin Heckman, Postgraduate Technical Assistant

Post-Implementation Review Update

Activities Since ASU 2016-13 Issuance

- Formed a Transition Resource Group (TRG)
- Responded to 80+ technical inquiries
- Conducted outreach with 200+ stakeholders
- Issued 6 Updates related to Topic 326
- Issued 2 Staff Q&As
- Conducted multiple educational workshops and roundtables
- Monitored 10-Qs, 10-Ks, earnings calls, and call reports

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Post-Implementation Review – Roundtable

- On May 20, 2021, the FASB hosted a virtual roundtable on implementation of the CECL standard and related technical issues
- FASB members and staff gathered additional feedback on
  - CECL implementation
  - Technical issues related to:
    - Purchased Credit Deteriorated (PCD) Assets
    - Troubled Debt Restructurings (TDRs)
- Participants included investors, regulators, auditors, and preparers who have adopted and not adopted CECL

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Roundtable Feedback

CECL Implementation

- Entities were well prepared to adopted CECL, and most implementation-related challenges in 2020 were COVID-19 related
- There was mixed feedback about CECL disclosures – Some participants expressed that CECL provides sufficient flexibility to tailor disclosures to different asset portfolios, inputs, and models, while others noted concern that this leads to a lack of comparability
- Analysts were complementary about the additional information provided by CECL adopters
- Analysts and preparers raised concerns about CECL's effect on income statement volatility

Purchased Credit Deteriorated (PCD) Assets

- Some participants stated a desire to have one model for all acquired assets
- Investors noted that two different models for acquired assets could be confusing, and also stated that they want credit losses reflected separately from yield in financial statements
- Some participants supported expanding the PCD accounting model to alleviate concerns about recognizing a day-one loss on purchased financial assets, but others expressed concerns about potential consequences from this approach

Troubled Debt Restructurings (TDRs)

- Most participants supported eliminating TDR designation and revisiting loan modification disclosures
- Participants generally noted that applying modification accounting to all loan modifications would be operable

Post-Implementation Review – Other Activities

- Post-Implementation Monitoring Process: The staff is continuing to monitor implementation of CECL by reviewing financial statements, using call reports and listening to earnings calls. In addition, the staff is still conducting individual outreach with stakeholders who have and have not yet adopted CECL.

- Workshops: CECL workshops will be held on a virtual basis to allow the staff to participate in sessions with various organizations across the country.
  - If organizations are interested in scheduling a workshop, please reach out to Jay Shah (JShah@FASB.org)

- Resources: More resources can be found on the FASB's credit losses implementation page: https://fasb.org/creditlosses

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