FASB issues ASU

Clarifications to fair value measurement implications of contractual sale restrictions

July 1, 2022

A new ASU clarifies that contractual sale restrictions are not considered in measuring equity securities at fair value.

Applicability

ASU 2022-03, Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions

Applies to all entities with investments in equity securities measured at fair value that are subject to a contractual sale restriction.

Fast facts, impacts, actions

ASU 2022-03 amends Topic 820 (fair value measurement) to clarify that a contractual sale restriction is not considered in measuring an equity security at fair value. The ASU uses two examples to differentiate between (1) a restriction that is a characteristic of the security (for which the effect of the restriction **is** included in the equity security's fair value because it is a security-specific characteristic) and (2) a contractual sale restriction (for which the effect of the restriction **is not** included in the equity security's fair value because it is an entity-specific characteristic). In addition, the amendments:

— clarify that an entity cannot recognize a contractual sale restriction as a separate unit of account (i.e. as a contra-asset or separate liability); and

— require new disclosures for all entities with equity securities subject to contractual sale restrictions.

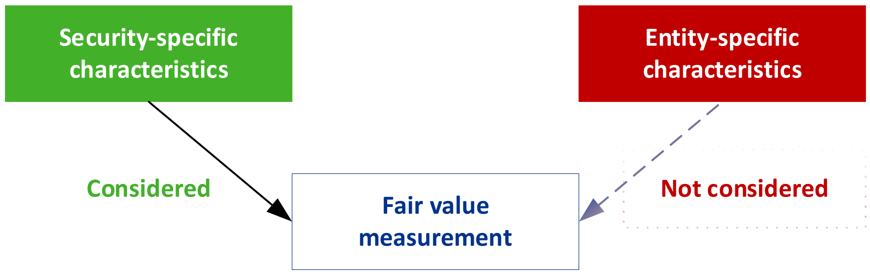
All entities except for those that qualify as an investment company under Topic 946 (investment companies) are required to apply the amendments prospectively. Any adjustments from adopting the amendments are recorded in current period earnings and the amounts are disclosed. Investment companies have different transition requirements to mitigate the effect of adopting this ASU on net asset value computations (see Effective dates and transition).

The ASU is intended to clarify existing US GAAP to reduce diversity in practice.

Action: This ASU will change practice for entities that currently factor contractual sale restrictions into fair value measurements. Those entities should start to determine the impact of adopting the ASU on their fair value measurements. They must also establish new valuation processes to *exclude* the effect of these restrictions from their fair value measurements. *All* entities with equity securities subject to contractual sale restrictions should become familiar with the new disclosure requirements, regardless of their current practice.

Background

Under Topic 820, when measuring fair value, an entity must consider characteristics that market participants would consider in a transaction at the measurement date. Topic 820 is explicit on what type of characteristics should be considered in measuring fair value.



However, it is not always clear whether a contractual sale restriction is a security-specific or an entity-specific characteristic, which has led to diversity in practice. An example of such a restriction is an underwriter's lock-up provision whereby an entity enters into an agreement with an underwriter that restricts the entity from selling its holdings for a specified period after a transaction, such as an initial public offering.

Stakeholders attribute the diversity in practice to conflicting guidance in Topic 820 on the appropriate unit of account when measuring fair value. Certain Topic 820 paragraphs (pre-ASU) indicated that the unit of account is the individual equity security, which suggested that a contractual sale restriction should be ignored in determining the security's fair value. However, an example in Topic 820 suggested that a legal or contractual sale restriction is a characteristic of the security (i.e. part of the unit of account of the security) and should therefore be included in the fair value measurement.

Observation: The ASU affects investment funds and similar entities that have been following the AICPA Accounting and Valuation Guide, *Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies.* Some entities following the guide may have treated an underwriter's lock-up provision (a type of contractual sale restriction) as a security-specific characteristic and considered it in measuring the fair value of equity securities. The ASU changes this practice.

Clarifications to Topic 820

The ASU clarifies that a contractual sale restriction on an equity security is an entity-specific characteristic and is **not** considered in measuring the equity security's fair value. The ASU uses two examples to help entities determine whether a restriction is entity-specific or security-specific.

The first example explains that a legal restriction preventing a security from being sold on a national securities exchange or an over-the-counter market is a security-specific characteristic. This is because a market participant buyer of the security in an assumed sale transaction would similarly be restricted from reselling the security in those markets and would therefore consider the restriction in pricing the security. Hence, the holder of the security applies a discount to the price of an otherwise unrestricted security for the effect of that legal restriction in measuring the equity security at fair value.

The second example addresses contractual sale restrictions. It indicates that a contractual arrangement in which a shareholder agrees to not sell the security for a certain period of time (e.g. a lock-up agreement or a market standoff agreement) is a characteristic of the shareholder (reporting entity) rather than a characteristic of the security. Therefore, the fair value of the equity security subject to the contractual sale restriction is measured by the reporting entity without considering the restriction.

Observation: At times, issuers of equity securities are required to measure those securities at fair value – e.g. when equity securities are issued as consideration in a business combination. Although the focus of ASU 2022-03 is fair value measurement by *holders* of equity securities, the amendments include a new cross-reference in paragraph 820-10-35-16D (liabilities and instruments classified in a reporting entity's shareholders' equity held by other parties as assets) to the new guidance on contractual sale restrictions. This addition therefore implies that *issuers* of equity securities that are subject to a contractual sale restriction apply similar guidance.

In addition, the ASU's basis for conclusions clarifies that entities that may have considered the effect of a contractual sale restriction in nonrecurring fair value measurements (e.g. equity securities issued as consideration in a business combination) in the past should not revise the carrying amount of the asset or liability if the measurement date was before the date of adopting ASU 2022-03.

The ASU also states that an entity cannot recognize the contractual sale restriction as a separate unit of account from the equity security (e.g. as a separate obligation).

Example: Contractual sale restriction as part of transaction price

ABC Corp. invests $9.9 million for 1 million shares of XYZ's equity securities. XYZ's equity securities are traded on an exchange with a quoted market price of $10 per share on the date of ABC's investment. As part of the investment, ABC enters into an agreement with XYZ that restricts it from selling its holdings for a specified period. The ASU clarifies that ABC must measure the fair value of the equity security using the quoted market price of the unrestricted equity security and cannot adjust that price to reflect the effect of the sale restriction. Therefore, ABC records the following journal entry upon investing in XYZ.

	Debit	*Credit*
Investment in XYZ (at fair value)	10,000,000	
Cash		9,900,000
Gain		100,000
To recognize investment in XYZ.		

Because the fair value of the security is based on the quoted market price unadjusted for the sale restriction, ABC recognizes a 'day 1' gain.

New disclosure requirements

The ASU requires all entities with investments in equity securities subject to contractual sale restrictions to disclose the:

— fair value of those investments;

— nature and remaining duration of the restriction(s); and

— circumstances that could cause a lapse in the restriction(s).

For investment companies, additional disclosures apply (see Effective dates and transition).

Effective dates and transition

	Public business entities	All other entities
Annual periods – Fiscal years beginning after	December 15, 2023	December 15, 2024
Interim periods – In year of adoption	Yes	Yes
Early adoption permitted?	Yes, for both interim and annual financial statements that have not yet been issued or made available for issuance.	

The ASU provides different transition guidance for (1) an entity that meets the definition of an investment company under Topic 946 and (2) all other entities.

Investment companies	All other entities
— For equity securities with a contractual sale restriction entered into or modified *on or after* the adoption date, apply the ASU on a prospective basis. — For equity securities with a contractual sale restriction entered into or modified *before* the adoption date: – continue to apply the existing accounting policy until the restrictions expire or are modified; and – disclose (1) the fair value of the equity securities subject to a contractual sale restriction to which the entity continues to apply a discount, (2) the nature and remaining duration of the restriction and (3) the circumstances that could cause a lapse in the restriction. — Any adjustments resulting from applying the ASU will be recognized as an adjustment to current-period earnings when the restrictions expire or are modified.	— Apply the ASU on a prospective basis to all equity securities with a contractual sale restriction as an adjustment to current-period earnings. This amount must also be disclosed in the period that the entity first applies the amendments.

Observation: The FASB provided different transition guidance for investment companies to avoid introducing ‘non-market-based volatility’ on the computation of net asset value (NAV). The FASB received feedback that many investment companies consider the effect of contractual sale restrictions in measuring the fair value of equity securities. ASU 2022-03 changes this practice, which will result in a higher estimated fair value for those securities. In the aggregate, the effect could be significant on an investment company’s overall investment portfolio, which is a direct input into the NAV computation. The transition guidance will help to minimize the effect of adoption on an investment company’s NAV by applying only to securities entered into or modified *after* adoption.

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