BDO BULLETIN

# FAIR VALUE MEASUREMENT: EQUITY SECURITIES SUBJECT TO CONTRACTUAL SALE RESTRICTIONS

JULY 2022

## SUMMARY

The FASB issued ASU 2022-03[1] (the "ASU") to clarify that a contractual restriction on the sale of an equity security is not considered part of the unit of account of the equity security and, therefore, is not considered in measuring the fair value of the equity security in accordance with ASC 820. The ASU also introduces new disclosure requirements for equity securities subject to contractual sale restrictions that are measured at fair value in accordance with ASC 820. The ASU will have a direct effect on the determination of net asset values reported by investment companies under ASC 946.

The ASU is effective for public business entities for fiscal years starting after December 15, 2023, and all other entities have an additional year. Early adoption is permitted for all entities.

## BACKGROUND

ASC 820 provides guidance on fair value measurement of an asset or a liability and states that an entity considers the characteristics of the asset or liability, including restrictions on the sale of the asset or liability, if a market participant also would take those characteristics into account. Key to that determination is the unit of account for the asset or liability being measured at fair value. While the unit of account is generally determined by the other relevant U.S. GAAP that requires or permits fair value measurement, in certain instances the unit of account is determined by ASC 820.

The existing guidance in ASC 820 includes conflicting guidance on what the unit of account is when measuring the fair value of an equity security, which has resulted in diversity in practice in applying the principles of fair value measurement. Certain paragraphs of ASC 820 indicate that the unit of account is an individual equity security exclusive of the contractual sale restriction and, therefore, the contractual sale restriction is specific to the entity holding the security. This indicates that adjusting the fair value of an equity security to reflect the effect of a separate contractual restriction is inappropriate. In contrast, an example in ASC 820 that addresses the effects of a sale restriction on an equity security indicates that a contractual sale restriction is considered a characteristic of that equity security and, therefore, is included within the unit of account, which indicates that the fair value of the unit of account would be adjusted to reflect the effect of a contractual sale restriction.

The ASU clarifies the guidance in ASC 820 to resolve the diversity in practice.

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[1] *Fair Value Measurement (ASC 820): Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions.*

## MAIN PROVISIONS

The ASU provides that in applying the fair value measurement guidance in ASC 820 to an equity security subject to a contractual restriction that prohibits the sale of the equity security:

- An entity measures that equity security at fair value on the basis of the price in the principal (or most advantageous) market on the measurement date.
- The contractual sale restriction does not change the market in which that equity security would be sold.

The ASU describes that a contractual sale restriction on an equity security could be imposed by any of the following:

- Underwriter lock-up agreements, which are typically executed in conjunction with an initial or secondary public offering to prohibit the sale of equity securities owned by certain investors for a specified period.
- Contractual arrangements in capital-raising transactions that do not involve an underwritten offering, generally referred to as lock-up agreements or market standoff agreements.
- Separate agreement between certain shareholders, for example, in private placements, private investments in public equity, or a de-SPAC transaction.[2]

Further, the amendments in this ASU are not limited only to equity securities with active markets (that is, Level 1 equity securities).

The ASU provides that the unit of account when measuring the fair value of an equity security is the individual equity security. A contractual sale restriction in an equity security is a characteristic of the reporting entity holding the equity security rather than a characteristic of the asset. Incorporating the effects of a contractual sale restriction (that is, applying a discount to the price of an identical equity security that is not subject to a contractual sale restriction) is not consistent with the unit of account. Therefore, the contractual sale restriction is not considered in measuring the fair value of an equity security, nor is it separately recognized or measured as its own unit of account. On the contrary, when a restriction is included within the unit of account of the asset, the restriction is a characteristic of the asset and is considered in measuring the fair value of the asset.

The ASU amends Example 6 in ASC 820 (ASC 820-10-55-51 through 55-52A) to illustrate the application of the new guidance and that the effect on the fair value measurement arising from a restriction on the sale or use of an equity security (asset) by a reporting entity will differ depending on whether the restriction would be taken into account by market participants when pricing the asset.

### Case A: Restriction Taken into Account

In Case A of Example 6, a company issues certain shares through a sale on a national securities exchange or an OTC market,[3] as well as through a private placement transaction. The shares issued through the private placement are not registered and are legally restricted from being sold on a national securities exchange or an OTC market until the shares are registered or the conditions necessary for an exemption from registration have been met. Therefore, a market participant would sell the private placement shares in a different market than the market used for the registered shares on the measurement date.

In this case, the restriction is included within the unit of account of the equity security, and a market participant would consider the inability to resell the security on a national securities exchange or an OTC market when pricing the equity security. Therefore, a reporting entity that holds the shares acquired through a private placement will consider that restriction a characteristic of the asset.

Accordingly, the entity will measure the fair value of the equity security on the basis of the market price of the similar unrestricted equity security adjusted to reflect the effect of the restriction.

### Case B: Restriction Not Taken into Account

Consider the same facts in Case A except that, in this case, a reporting entity holds the shares that are eligible for sale on a national securities exchange or an OTC market (rather than the private placement shares as in Case A). Separately, the entity enters into a contractual arrangement in which it agrees not to sell the shares it holds for a certain time period. That contractual arrangement imposing the sale restriction is separate from the legal documents that establish the rights and obligations of all holders of the particular class of shares the entity holds.

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[2] A business combination involving a special-purpose acquisition company (SPAC).

[3] Over-the-Counter market.

In this case, the restriction is not included in the unit of account (the equity security) and therefore is not a characteristic of the asset (the equity security). The equity security subject to the contractual sale restriction is identical to an equity security that is not subject to a contractual sale restriction. Therefore, the fair value of the equity security is measured on the basis of the market price of the same equity security without the contractual sale restriction and is not adjusted to reflect the reporting entity's inability to sell the equity security on the measurement date.

The ASU does not change the principles of fair value measurement in ASC 820. Additionally, the FASB does not intend for the ASU to change the guidance on the recognition and measurement of contractual arrangements accounted for under other areas of U.S. GAAP as a separate unit of account.[4]

### BDO INSIGHTS

Pursuant to the existing guidance in ASC 820-10-55-52, many investment companies[5] treat the contractual restriction as an attribute of the equity security and therefore measure the fair value of the equity security that is subject to a contractual resale on the basis of the market price of the similar unrestricted equity security adjusted for a discount to reflect the effect of the restriction. The amendments in this ASU will change current practice and thus will impact the net asset value (NAV)[6] of investment companies and the determination of asset-based fees (e.g., management fees) charged by fund managers.

## DISCLOSURES

The ASU requires the following additional disclosures for equity securities subject to contractual sale restrictions that are measured at fair value in accordance with ASC 820:

- The fair value reflected in the balance sheet.
- The nature and remaining duration of the restrictions.
- The circumstances that could cause a lapse in the restrictions.

Entities are required to consider the existing guidance in ASC 820-10-50-1D when disclosing the above information, including how much aggregation or disaggregation to undertake when disclosing that information. Equity securities restricted from sale because they are pledged as collateral and included in other disclosures required by other U.S. GAAP are not included in the new disclosures.

## EFFECTIVE DATES AND TRANSITION

The ASU is effective for public business entities for fiscal years beginning after December 15, 2023, and interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2024, and interim periods within those fiscal years. Early adoption is permitted for both interim and annual financial statements that have not yet been issued or made available for issuance.

The ASU will be applied using the following transition methods:

[4] Basis for Conclusions (BC16) of the ASU.
[5] That is, entities that qualify as investment companies under ASC 946.
[6] The NAV is the price at which investment companies commonly transact with their investors.

| TYPE OF ENTITY | TRANSITION METHOD |
|---|---|
| All entities except investment companies under ASC 946 | Prospective to all equity securities. Any resulting adjustments are recognized in current period earnings at the date of adoption. |
| Entities that qualify as investment companies under ASC 946 | Prospective to equity securities that are executed or modified on or after the date of adoption. Any equity securities subject to contractual sale restrictions that were executed prior to the adoption date will continue to be accounted for under the accounting policy applied prior to the adoption date until the contractual restrictions expire or are modified (that is, if an investment company was incorporating the effects of the restriction in the measurement of fair value, it would continue to do so for existing investments. |

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The ASU is **available here.**