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ASU 2022-03

Fair Value of Equity Securities Subject to Contractual Restrictions

On June 30, 2022, the FASB issued Accounting Standards Update (ASU) 2022-03, *Fair Value Measurement (Topic 820): Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions*. The amendments in ASU 2022-03 are intended to increase comparability of financial information across reporting entities that have investments in equity securities measured at fair value that are subject to contractual restrictions on the holder of the equity security preventing the sale of those securities. Additionally, the ASU introduces new disclosure requirements to provide investors with information about contractual sale restrictions including the nature and remaining duration of the restrictions.

FASB *Accounting Standards Codification* (FASB ASC) 820, *Fair Value Measurement*, indicates that, when measuring the fair value of an asset or a liability, a reporting entity should consider 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.

Some stakeholders noted that FASB ASC 820 contains conflicting guidance on what the unit of account is when measuring the fair value of an equity security. This has resulted in diversity in practice on whether the effects of a contractual restriction that prohibits the sale of an equity security should be considered in measuring that equity security's fair value.

The amendments in ASU 2022-03 clarify that a contractual restriction on the sale of an equity security on the holder of the equity security is not considered part of the unit of account of the equity security and, therefore, is not considered in measuring fair value. In these situations, the amendments also clarify that an entity cannot, as a separate unit of account, recognize and measure a contractual sale restriction. Conversely, if a contractual restriction on the sale of the equity security is on the equity security itself, that contractual restriction is considered in measuring fair value. ASU 2022-03 has two examples that contrast these situations and are discussed further below.

The amendments in ASU 2022-03 also require the following disclosures for equity securities subject to contractual sale restrictions:

1. The fair value of equity securities subject to contractual sale restrictions reflected in the balance sheet
2. The nature and remaining duration of the restriction(s)
3. The circumstances that could cause a lapse in the restriction(s)

Below are two examples, adapted from ASU 2022-03, to illustrate the guidance.

<u>Example 1 – Restriction on Equity Security Reflected in Fair Value Measurement</u>

Class A shares are sold on a national securities exchange, an over-the-counter market, as well as through a private placement transaction. The Class A shares issued through a private placement are not registered and are legally restricted from being sold on a national securities exchange or an over-the-counter market until the shares are registered or the conditions necessary for an exemption from registration have been satisfied. A market participant would sell the private placement Class A shares in a different market than the market used for registered Class A shares on the measurement date.

Because that restriction would be included within the unit of account of the equity security, a market participant would consider the inability to resell the security on a national securities exchange or an over-the-counter market when pricing the equity security; therefore, the reporting entity that holds the Class A shares acquired through a private placement transaction would consider that restriction a characteristic of the asset. In that case, the reporting entity should 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.

<u>Example 2 – Restriction on Equity Security Not Reflected in Fair Value Measurement</u>

A reporting entity holds Class A shares that are eligible for sale on a national securities exchange or an over-the-counter market. Separately, the reporting entity enters into a contractual arrangement in which it agrees that it will not sell the Class A shares for a certain time period. That arrangement may be referred to as a lock-up agreement or a market standoff agreement or may be the result of a provision within a separate agreement between certain shareholders (that is, separate from the legal documents that establish the rights and obligations of all holders of a particular class of stock).

In that instance, the restriction is not included in the unit of account and, therefore, is not a characteristic of the asset. 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 subject to the contractual sale restriction should be measured on the basis of the market price of the same equity security without the contractual sale restriction and should not be adjusted to reflect the reporting entity's inability to sell the equity security on the measurement date.

<u>Effective Date and Transition</u>

For public business entities, the amendments in ASU 2022-03 are effective 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.

For all entities except investment companies as defined under FASB ASC 946, *Financial Services—Investment Companies*, the amendments in ASU 2022-03 should be applied prospectively with any adjustments from the adoption of the amendments recognized in earnings and disclosed on the date of adoption.

An entity that qualifies as an investment company under FASB ASC 946 should apply the amendments in ASU 2022-03 to an investment in an equity security subject to a contractual sale restriction that is executed or modified on or after the date of adoption. An investment company with an equity security subject to a contractual sale restriction that was executed before the date of adoption should continue to account for the equity security until the contractual restrictions expire or are modified using the accounting policy applied before the adoption of the amendments (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).

Practice Note: The FASB decided that investment companies under FASB ASC 946 should have specialized transition guidance because of the direct effect that the amendments in this ASU will have on the computation of net asset value or NAV. The FASB wanted to avoid introducing nonmarket-based volatility that would disproportionately affect transaction values on the date of adoption if investment companies applied the amendments to all equity securities on the date of adoption.