FINANCIAL ACCOUNTING SERIES

ACCOUNTING STANDARDS UPDATE

No. 2022-03
June 2022

Fair Value Measurement (Topic 820)

Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions

An Amendment of the *FASB Accounting Standards Codification*®

Financial Accounting Standards Board

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401 Merritt 7
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Please ask for our Product Code No. ASU2022-03.

FINANCIAL ACCOUNTING SERIES (ISSN 0885-9051) is published monthly with the exception of January, February, March, May, October, and November by the Financial Accounting Foundation, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116. Periodicals postage paid at Norwalk, CT and at additional mailing offices. The full subscription rate is $345 per year. POSTMASTER: Send address changes to Financial Accounting Series, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116. | **No. 515**

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Summary

Why Is the FASB Issuing This Accounting Standards Update (Update)?

The FASB is issuing this Update (1) to clarify the guidance in Topic 820, Fair Value Measurement, when measuring the fair value of an equity security subject to contractual restrictions that prohibit the sale of an equity security, (2) to amend a related illustrative example, and (3) to introduce new disclosure requirements for equity securities subject to contractual sale restrictions that are measured at fair value in accordance with Topic 820.

Stakeholders asserted that the language in the illustrative example 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. Some stakeholders apply a discount to the price of an equity security subject to a contractual sale restriction, whereas other stakeholders consider the application of a discount to be inappropriate under the principles of Topic 820.

Who Is Affected by the Amendments in This Update?

The amendments in this Update affect all entities that have investments in equity securities measured at fair value that are subject to a contractual sale restriction.

What Are the Main Provisions?

The amendments in this Update 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 fair value. The amendments also clarify that an entity cannot, as a separate unit of account, recognize and measure a contractual sale restriction. The amendments in this Update 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).

How Do the Main Provisions Differ from Current Generally Accepted Accounting Principles (GAAP) and Why Are They an Improvement?

The amendments in this Update do not change the principles of fair value measurement. The amendments clarify those principles when measuring the fair value of an equity security subject to a contractual sale restriction and improve current GAAP by reducing diversity in practice, reducing the cost and complexity in measuring fair value, and increasing comparability of financial information across reporting entities that hold those investments.

When Will the Amendments Be Effective and What Are the Transition Requirements?

For public business entities, the amendments in this Update 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 Topic 946, Financial Services—Investment Companies, the amendments in this Update 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 Topic 946 should apply the amendments in this Update 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).

Amendments to the *FASB Accounting Standards Codification*®

Introduction

1. The Accounting Standards Codification is amended as described in paragraphs 2–7. In some cases, to put the change in context, not only are the amended paragraphs shown but also the preceding and following paragraphs. Terms from the Master Glossary are in **bold** type. Added text is <u>underlined</u>, and deleted text is ~~struck out~~.

Amendments to Master Glossary

2. Add the Master Glossary term *Equity Security* to Subtopic 820-10 as follows:

Equity Security (first definition)

Any security representing an ownership interest in an entity (for example, common, preferred, or other capital stock) or the right to acquire (for example, warrants, rights, forward purchase contracts, and call options) or dispose of (for example, put options and forward sale contracts) an ownership interest in an entity at fixed or determinable prices. The term equity security does not include any of the following:

a. Written equity options (because they represent obligations of the writer, not investments)
b. Cash-settled options on equity securities or options on equity-based indexes (because those instruments do not represent ownership interests in an entity)
c. Convertible debt or preferred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the option of the investor.

Amendments to Subtopic 820-10

3. Amend paragraphs 820-10-35-6B, 820-10-35-16D, 820-10-35-36B, 820-10-55-51 through 55-52, and 820-10-55-90 and the related headings and add paragraphs 820-10-50-6B and 820-10-55-52A and the related headings, with a link to transition paragraph 820-10-65-13, as follows:

Fair Value Measurement—Overall

Subsequent Measurement

> Definition of Fair Value

> > The Asset or Liability

820-10-35-2B A fair value measurement is for a particular asset or liability. Therefore, when measuring fair value a reporting entity shall take into account the characteristics of the asset or liability if market participants would take those characteristics into account when pricing the asset or liability at the measurement date. Such characteristics include, for example, the following:

a. The condition and location of the asset
b. Restrictions, if any, on the sale or use of the asset.

820-10-35-2C The effect on the measurement arising from a particular characteristic will differ depending on how that characteristic would be taken into account by market participants. Paragraph 820-10-55-51 illustrates a restriction's effect on fair value measurement.

> > The Transaction

820-10-35-6B Although a reporting entity must be able to access the market, the reporting entity does not need to be able to sell the particular asset or transfer the particular liability on the measurement date to be able to measure fair value on the basis of the price in that market. For example, an **{add glossary link to 1st definition}equity security{add glossary link to 1st definition}** that an entity cannot sell on the measurement date because of a contractual sale restriction shall be measured at fair value on the basis of the price in the principal (or most advantageous) market. A contractual sale restriction does not change the market in which that equity security would be sold (see paragraphs 820-10-55-52 through 55-52A).

> > Application to Liabilities and Instruments Classified in a Reporting Entity's Shareholders' Equity

> > > General Principles

> > > > Liabilities and Instruments Classified in a Reporting Entity's Shareholders' Equity Held by Other Parties as Assets

820-10-35-16D When measuring the fair value of a liability or an equity instrument held by another party as an asset, a reporting entity shall adjust the quoted price of the asset only if there are factors specific to the asset that are not applicable to the fair value measurement of the liability or equity instrument. When the asset held by another party includes a characteristic restricting its sale (see paragraphs 820-10-35-6B and 820-10-35-36B), the fair value of the corresponding liability or equity instrument also would include the effect of the restriction. Some factors that may indicate that the quoted price of the asset should be adjusted include the following:

a. The quoted price for the asset relates to a similar (but not identical) liability or equity instrument held by another party as an asset. For example, the liability or equity instrument may have a particular characteristic (for example, the credit quality of the issuer) that is different from that reflected in the fair value of the similar liability or equity instrument held as an asset.
b. The unit of account for the asset is not the same as for the liability or equity instrument. For example, for liabilities, in some cases the price for an asset reflects a combined price for a package comprising both the amounts due from the issuer and a third-party credit enhancement. If the unit of account for the liability is not for the combined package, the objective is to measure the fair value of the issuer's liability, not the fair value of the combined package. Thus, in such cases, the reporting entity would adjust the observed price for the asset to exclude the effect of the third-party credit enhancement. See paragraph 820-10-35-18A for further guidance.

> Inputs to Valuation Techniques

> > General Principles

820-10-35-36B A reporting entity shall select inputs that are consistent with the characteristics of the asset or liability that market participants would take into account in a transaction for the asset or liability (see paragraphs 820-10-35-2B through 35-2C). In some cases, those characteristics result in the application of an adjustment, such as a premium or discount (for example, a control premium or noncontrolling interest discount). However, a fair value measurement shall not incorporate a premium or discount that is inconsistent with the unit of account in the Topic that requires or permits the fair value measurement. Premiums or discounts that reflect size as a characteristic of the reporting entity's holding (specifically, a blockage factor that adjusts the quoted price of an asset or a liability because the market's normal daily trading volume is not sufficient to absorb the quantity held by the entity, as described in paragraph 820-10-35-44) rather than as a characteristic of the asset or liability (for example, a control premium when measuring the fair value of a controlling interest) are not permitted in a fair value measurement. Similarly, a discount applied to the price of an equity security because of a contractual sale restriction is inconsistent with the unit of account being the equity security. A contractual sale restriction is a characteristic of the reporting entity holding the equity security rather than a characteristic of the asset and, therefore, is not considered in measuring the fair value of an equity security (see paragraphs 820-10-55-52 through 55-52A). A contractual sale restriction prohibiting the sale of an equity security is a characteristic of the reporting entity holding the equity security and shall not be separately recognized as its own unit of account. In all cases, if there is a quoted price in an active market (that is, a Level 1 input) for an asset or a liability, a reporting entity shall use that quoted price without adjustment when measuring fair value, except as specified in paragraph 820-10-35-41C.

Disclosure

> Equity Securities Subject to Contractual Sale Restrictions

820-10-50-6B An entity shall disclose the following information for equity securities subject to contractual sale restrictions:

a. The fair value of equity securities subject to contractual sale restrictions
b. The nature and remaining duration of the restriction(s)
c. Circumstances that could cause a lapse in the restriction(s).

If an entity has multiple investments in equity securities subject to contractual sale restrictions, the entity shall consider the guidance in paragraph 820-10-50-1D when disclosing the information required in (a) through (c). Equity securities restricted from sale because they are pledged as collateral and included in other disclosures required by other Topics shall not be included in the information required in (a) through (c).

Implementation Guidance and Illustrations

> Illustrations

> > Example 6: Restricted Assets

820-10-55-51 The effect on a fair value measurement arising from a restriction on the sale or use of an asset by a reporting entity will differ depending on whether the restriction would be taken into account by market participants when pricing the asset. When the restriction is included within the unit of account of the asset, the restriction is a characteristic of the asset and should be considered in measuring the fair value of the asset. Cases A and B illustrate the effect of restrictions when measuring the fair value of an asset.

a. Subparagraph superseded by Accounting Standards Update No. 2011-04

b. Subparagraph superseded by Accounting Standards Update No. 2011-04.

> > > Case A: Restriction on the Sale of an Equity ~~Instrument~~Security

> > > > Restriction Taken into Account

820-10-55-52 ~~A reporting entity holds an equity instrument (a **financial asset**) for which sale is legally or contractually restricted for a specified period. (For example, such a restriction could limit sale to qualifying investors, as may be the case in accordance with Rule 144 or similar rules of the Securities and Exchange Commission [SEC].) The restriction is a characteristic of the instrument and, therefore, would be transferred to market participants. In that case, the fair value of the instrument would be measured on the basis of the quoted price for an otherwise identical unrestricted equity instrument of the same issuer that trades in a public market, adjusted to reflect the effect of the restriction. The adjustment would reflect the amount market participants would demand because of the risk relating to the inability to access a public market for the instrument for the specified period.~~Company X issues Class A shares through a sale on a national securities exchange or an over-the-counter market as well as through a private placement transaction. Because the Class A shares issued through the 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. The adjustment will vary depending on all of the following:

a. The nature and remaining duration of the restriction
b. The extent to which buyers are limited by the restriction (for example, there might be a large number of qualifying investors)
c. Qualitative and quantitative factors specific to both the instrument and the issuer.

> > > > Restriction Not Taken into Account

820-10-55-52A A reporting entity holds Class A shares of Company X 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, consistent with the guidance in paragraphs 820-10-35-6B and 820-10-35-36B, 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.

> > Example 8: Measuring Fair Value When the Volume or Level of Activity for an Asset or a Liability Has Significantly Decreased

820-10-55-90 This Example illustrates the use of judgment when measuring the fair value of a **{add glossary link}**financial asset**{add glossary link}** when there has been a significant decrease in the volume or level of activity for the asset when compared with normal market activity for the asset (or similar assets). **[The remainder of this paragraph is not shown here because it is unchanged.]**

4. Add paragraph 820-10-65-13 and its related heading as follows:

Transition and Open Effective Date Information

> Transition Related to Accounting Standards Update No. 2022-03, *Fair Value Measurement (Topic 820): Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions*

820-10-65-13 The following represents the transition and effective date information related to Accounting Standards Update No. 2022-03, *Fair Value Measurement (Topic 820): Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions*:

a. For **public business entities**, the pending content that links to this paragraph shall be effective for fiscal years, including interim periods within those fiscal years, beginning after December 15, 2023. Early adoption is permitted.

b. For all other entities, the pending content that links to this paragraph shall be effective for fiscal years, including interim periods within those fiscal years, beginning after December 15, 2024. Early adoption is permitted for both interim and annual financial statements that have not yet been issued or made available for issuance.
c. An entity shall apply the pending content that links to this paragraph to **{add glossary link to 1st definition}equity securities{add glossary link to 1st definition}** within the scope of the pending content that links to this paragraph as follows:
   1. For entities that meet the definition of an investment company in accordance with the guidance in paragraphs 946-10-15-4 through 15-9, on a prospective basis to an equity security in which the contractual restriction that prohibits the sale of the equity security is executed or modified on or after the date at which the investment company first applies the pending content that links to this paragraph. An investment company that holds an equity security that is subject to a contractual sale restriction executed before the date at which the investment company first applies the pending content that links to this paragraph shall continue to account for that equity security using the accounting policy applied before the adoption of the pending content that links to this paragraph until the contractual sale restriction expires or is modified. An entity shall account for a modification to a contractual sale restriction in accordance with (c)(2) on the date of modification. Any adjustments as a result of applying the pending content that links to this paragraph shall be recognized as an adjustment to current-period earnings on the date the contractual sale restriction is modified.
   2. For all other entities, on a prospective basis to all equity securities. Any adjustments as a result of applying the pending content that links to this paragraph shall be recognized as an adjustment to current-period earnings on the date at which an entity first applies the pending content that links to this paragraph.
d. An entity that adopts the pending content that links to this paragraph in accordance with (c)(1) shall disclose the following in each period that the entity continues to apply a discount to equity securities subject to contractual sale restrictions executed before adopting the pending content that links to this paragraph:
   1. The fair value of equity securities subject to a contractual sale restriction on the statement of financial position to which the entity continues to apply a discount.
   2. The nature and remaining duration of the contractual sale restriction.
   3. The circumstances that could cause a lapse in the restriction.

   The equity securities included in (d)(1) through (3) shall be excluded from the amounts disclosed as required by paragraph 820-10-50-6B.
e. An entity that adopts the pending content that links to this paragraph in accordance with (c)(2) shall disclose the amount recognized as an

adjustment to earnings in the period that the entity first applies the pending content that links to this paragraph.

Amendments to Subtopic 940-820

5. Amend paragraph 940-820-30-1, with a link to transition paragraph 820-10-65-13, as follows:

Financial Services—Brokers and Dealers—Fair Value Measurement

Initial Measurement

940-820-30-1 This Section does not purport to delineate all factors that may be considered by management in determining the **fair value** assigned to a particular financial instrument. However, the following is a list of certain factors that have been taken into consideration by broker-dealers as part of the determination of fair value:

a. Financial standing of the issuer
b. Business and financial plan of the issuer
c. Cost at date of purchase
d. The liquidity of the market
e. ~~Contractual restrictions~~Restrictions on salability (see paragraphs 820-10-35-6B and 820-10-35-36B)
f. Pending public offering with respect to the financial instrument
g. Pending reorganization activity affecting the financial instrument (such as merger proposals, tender offers, debt restructurings, and conversions)
h. Reported prices and the extent of public trading in similar financial instruments of the issuer or comparable entities
i. Ability of the issuer to obtain needed financing
j. Changes in the economic conditions affecting the issuer
k. A recent purchase or sale of a security of the entity
l. Pricing by other dealers in similar securities.

Amendments to Status Sections

6. Amend paragraph 820-10-00-1, by adding the following items to the table, as follows:

820-10-00-1 The following table identifies the changes made to this Subtopic.

Paragraph	Action	Accounting Standards Update	Date
Equity Security (1st def.)	Added	2022-03	06/30/2022
820-10-35-6B	Amended	2022-03	06/30/2022
820-10-35-16D	Amended	2022-03	06/30/2022
820-10-35-36B	Amended	2022-03	06/30/2022
820-10-50-6B	Added	2022-03	06/30/2022
820-10-55-51	Amended	2022-03	06/30/2022
820-10-55-52	Amended	2022-03	06/30/2022
820-10-55-52A	Added	2022-03	06/30/2022
820-10-55-90	Amended	2022-03	06/30/2022
820-10-65-13	Added	2022-03	06/30/2022

7. Amend paragraph 940-820-00-1, by adding the following item to the table, as follows:

940-820-00-1 The following table identifies the changes made to this Subtopic.

Paragraph	Action	Accounting Standards Update	Date
940-820-30-1	Amended	2022-03	06/30/2022

The amendments in this Update were adopted by the affirmative vote of four members of the Financial Accounting Standards Board. Messrs. Cannon, Jones, and Kroeker dissented.

Messrs. Cannon, Jones, and Kroeker dissent from the issuance of this Update because they do not support the conclusion that precludes all entities from incorporating the effects of a contractual sale restriction in determining fair value. They recognize that Topic 820 differentiates between contractual restrictions that may be considered characteristics of an asset and those that are characteristics of an entity (or the holder of the asset). They also recognize that many (but not all) stakeholders have concluded that contractual sale restrictions on equity securities should be treated as characteristics of a holding entity and, thus, excluded when measuring fair value. However, they believe that for an equity security, the distinction of whether a legal or contractual restriction on a sale is asset specific or entity specific is not meaningful from an economic point of view because the value of an equity security typically can be fully realized only through sale. Furthermore, in that case, the distinction is not meaningful because the restriction precludes transfer or any realization of the value of the asset and, thus, a determination of whether the restriction would transfer with a sale of the equity security is only hypothetical. As discussed below, contractual sale restrictions have economic substance, and that substance should not be disregarded for accounting purposes.

Consistent with research performed in the development of the amendments in this Update, Messrs. Cannon, Jones, and Kroeker note that restrictions on sale because of underwriter lock ups (and other similar contractual sale restrictions) are primarily put in place to enhance share price performance during the restricted period and are designed to add value to the unrestricted shares. Underwriters put in place restrictions on shares to reduce supply during the initial period of trading. Because the market is aware of that lock up, the bid-offer quotes during the lock-up period reflect that limitation of supply. Notwithstanding other idiosyncratic factors for a particular stock, the market price generally declines as the lock-up expiration date approaches and then stabilizes in the days after the expiration. That occurs regardless of whether there are actual sales of the securities subject to the lock-up agreement. The potential of the additional available float appears to put downward pressure on the price. Academic research identified by the FASB staff generally supports that view on how the market prices consider lock-up agreements. Thus, the contractual sale restrictions appear to have an impact on the price of equity securities not subject to the sale restriction. However, such restrictions clearly have a differential impact from an economic point of view on the owners of restricted shares that are precluded from realizing value for the shares during the restricted period.

Messrs. Cannon, Jones, and Kroeker note that using an unadjusted market price for shares subject to contractual sale restrictions, without giving any recognition to contractual sale restrictions, has the potential to reduce decision-useful information for users of financial statements. Furthermore, they believe that the conclusion in this Update will result in the establishment of a clear disconnect between economic fair value and accounting fair value when an equity security is subject to such a restriction (other than in connection with being pledged as collateral) that is not included in the unit of account for purposes of measuring the asset at fair value. Valuation specialists point out that equity securities subject to contractual lock ups are exposed to liquidity and volatility risk in a manner that differs when compared with an equity security that is not subject to a contractual sale restriction. That economic fair value impact is consistent with the impact on economic fair value of restrictions in a security that cannot be offered to the public for sale without first being registered under the Securities Act of 1933, referred to by the U.S. Securities and Exchange Commission (SEC) as a "restricted security."

Typical underwriter contractual sale restrictions have severe restrictions on realizing value, often more limiting than the restrictions in a restricted security. For example, the contractual terms of underwriter sale restrictions often also limit the holder's ability to reduce liquidity and volatility risk by precluding hedging of the equity security through short sales or derivative purchases. The security also cannot be borrowed against. Restricted securities may not include similar preclusions on monetization of value and can often be sold, albeit to a more limited class of potential buyers. However, Messrs. Cannon, Jones, and Kroeker note that existing GAAP clearly indicates that in the case of a restricted security, the impact of the restriction(s) is considered a characteristic of the asset and, thus, is reflected in the determination of value. That results in a lower value compared with an unrestricted security with a readily determined value. While recognizing the challenge of estimating the appropriate discount, and the ease of applying the current market price, Messrs. Cannon, Jones, and Kroeker do not believe that difficulty in measurement is a compelling reason to ignore the economics of the contractual restrictions on sale.

In the view of Messrs. Cannon, Jones, and Kroeker, systematically overstating the accounting fair value of equity securities subject to contractual sale restrictions is particularly problematic for investment companies. As described in Topic 946, one of the fundamental elements of an investment company is that it is managed on a fair value basis. Specifically, Topic 946 states:

> An investment company's activities typically demonstrate that fair value is the primary measurement attribute used to evaluate the financial performance of and to make investment decisions for substantially all of its investments. Also, an investment company typically transacts with investors on the basis of net asset value per share and incurs asset-based fees, both of which are based on the fair value of its investments. [paragraph 946-10-55-27]

Unlike with most entities, the valuation of securities directly affects the price at which the shares of the investment company are sold to or redeemed from investors, in particular, individual investors. In addition to an overstatement of investments and, thus, net asset value (NAV), that conclusion has the potential to result in excess compensation to investment managers and may result in less meaningful reporting of investment company performance. Investment companies report NAV on a periodic basis, including many that report NAV daily, and investors use that information to make portfolio allocation decisions. Under the amendment in this Update, that information will not reflect economic fair value and could skew investment decisions in the view of Messrs. Cannon, Jones, and Kroeker.

An issue similar to the one noted in the preceding paragraph was addressed by the SEC in ASR No. 113, *Restricted Securities*. ASR 113 directly addresses the valuation of restricted securities (specifically addressing those securities that cannot be offered to the public for sale without first being registered with the SEC). ASR 113 was issued in response to an increase in the net assets invested in restricted securities by investment companies and established the following:

1. Restricted securities are similar but not identical to unrestricted securities of the same class; therefore, the market quote for an unrestricted security is not the equivalent of a market quote for a restricted security.

2. Valuation of restricted securities at the market quotations for unrestricted securities would, except for most unusual circumstances, be improper. As a general principle, the current fair value of restricted securities would appear to be the amount that an owner might reasonably expect to receive for the restricted securities upon their current sale. That depends on the restricted securities' inherent worth, without regard to the restrictive feature, adjusted for any diminution in value resulting from the restrictive feature.
3. The discount factor used to reflect diminution in value attributable to the restrictive feature should not be based on an arbitrary percentage or an amortization of the initial difference in price between the transaction price for the restricted securities and the unrestricted market price. The discount factor should be an amount that changes over time because of how relevant inputs change, such as the length of time remaining on the restriction.

While the guidance in ASR 113 addresses a narrower fact pattern and does not mention contractual sale restrictions, Messrs. Cannon, Jones, and Kroeker see no reason that such contractual restrictions on sale should be viewed as having an economically different impact on determining fair value (and, thus, the NAV of an investment company) and, in turn, a similar potential detrimental impact on investors. Perhaps most notably, in ASR 113 the SEC cautioned against overvaluation of restricted securities because of the direct connection to the impact on investors:

> **1. The Problems of Valuation**
>
> It is critically important that an investment company properly value its portfolio securities. It is obvious, for example, that any distortion in the valuation of a restricted security held by an investment company will distort the price at which the shares of the investment company are sold or redeemed. It is also clear that investment managers who are compensated on the basis of net asset value or performance may be unduly compensated if a restricted security, purchased at a discount from the market quotation for unrestricted securities of the same class, is overvalued. In such a case, investors may also be misled by the reported performance of the investment company.

Accordingly, while Messrs. Cannon, Jones, and Kroeker do not support the conclusion in this Update, they do support an alternative approach that would incorporate the effects of contractual sale restrictions (other than restrictions imposed on equity securities as a result of an entity pledging such securities as collateral because in that case, such restrictions are generally reflected in the pricing of the related debt) in determining fair value. They believe that accounting for the economic impacts resulting from the sale restrictions would provide information that financial statement users would consider relevant and decision useful. They note that requiring entities to ignore contractual obligations by prohibiting recognition of the restrictions, either as part of the value of the equity security or as a separate obligation, results in a requirement for entities to value such security at initial measurement at an amount that exceeds the economic value (the price paid) in an observable exchange transaction—resulting in a day one gain equal to the value of the restriction. Furthermore, in the case of investment companies, Messrs. Cannon, Jones, and Kroeker believe that the obligations imposed by the restrictions directly affect the economics of transactions with investors.

Specifically, they support an approach that would amend Topic 820 (to address the types of restrictions within the scope of the amendments in this Update) to require that such restrictions be incorporated in the determination of fair value. They point out that the guidance that differentiates between restrictions that are asset specific versus entity specific contained in Topic 820 is not immutable and would, in their view, be improved by an amendment to Topic 820.

Alternatively, they also would support an approach that amends Topic 321, Investments—Equity Securities, to require (1) recognition of contractual obligations imposed by contractual sale restrictions as a separate unit of account from an individual equity security and (2) accounting for both the equity security and a contractual sale restriction agreement (if one exists). Under that approach, contractual sale restrictions would be treated as a separate obligation, rather than as a characteristic of the equity security, and thus the fair value measurement for the equity security would, as the majority of the Board supports, not be affected by such restrictions. That approach would reflect the view that a contractual sale restriction imposes obligations that have economic substance, and those obligations should be recognized and measured, albeit under this view, as a unit of account separate from the value of the equity security. The contractual sale restriction could be presented as a contra-asset or as a liability, reflecting the obligation to refrain from selling the related asset during the period of the restriction. The Board also rejected that view and provided guidance prohibiting accounting for contractual sale restrictions as a separate obligation. Messrs. Cannon, Jones, and Kroeker note that the guidance in Topic 820 does not address what assets and liabilities should be recognized (including the identification of performance obligations) or how recognized items should be measured. Rather, the guidance in Topic 820 provides a definition and sets out a framework for measuring fair value.

Either approach would result in the de facto conclusion that a contractual sale restriction must be considered along with an equity security for purposes of determining the appropriate accounting, and Messrs. Cannon, Jones, and Kroeker would support either approach for all entities. However, because the Board rejected an amendment to the guidance under Topic 820 and also rejected providing separate unit of accounting guidance as an amendment to Topic 321, a third alternative that would address situations in which this issue is likely most prevalent would be to provide industry-specific guidance for entities that report their activities and/or all investments on a fair value basis (for example, investment companies, broker dealers, and pension plans—“fair value entities”). Thus, alternatively, Messrs. Cannon, Jones, and Kroeker would as a third alternative support an approach that treats such contractual sale restrictions as a separate unit of account from the equity security, but those separate contracts nonetheless would have an economic value (or would reduce the economic value of other assets). Under that approach, they would support an amendment to existing industry-specific guidance for “fair value entities” to specifically require that such contractual sale restrictions be recognized and measured at fair value, consistent with the reporting of all investments at fair value.

Members of the Financial Accounting Standards Board:

Richard R. Jones, *Chair*
James L. Kroeker, *Vice Chairman*
Christine A. Botosan
Gary R. Buesser
Frederick L. Cannon
Susan M. Cosper
Marsha L. Hunt

Background Information and Basis for Conclusions

Introduction

BC1. The following summarizes the Board's considerations in reaching the conclusions in this Update. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

Background Information

BC2. The Board is issuing this Update (a) to clarify the guidance in Topic 820 when measuring the fair value of an equity security subject to contractual restrictions that prohibit the sale of an equity security, (b) to amend a related illustrative example, and (c) to introduce new disclosure requirements for equity securities subject to contractual sale restrictions that are measured at fair value in accordance with Topic 820, thereby reducing diversity in practice without changing the fundamental principles of Topic 820.

BC3. Topic 820 states 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; in other words, the specific asset or liability (or group of assets and/or liabilities) being sold and whether the restriction should be included as part of the sale. Generally, the unit of account is determined by the relevant Topic or Subtopic that requires or permits fair value measurement, but in certain instances the unit of account is determined by Topic 820.

BC4. Stakeholders asserted that Topic 820 contains conflicting guidance on what the unit of account is when measuring the fair value of an equity security. In certain paragraphs, the guidance indicates that the unit of account is an individual equity security (that is, exclusive of the contractual sale restriction and, therefore, the contractual sale restriction is specific to the entity holding the security). As a result, some stakeholders concluded that adjusting the fair value of an equity security to reflect the effect of a separate contractual restriction is not appropriate. However, before the amendments in this Update became finalized, an illustrative example within Topic 820 that addressed the consideration of the effects of a restriction on the ability to sell an equity security indicated that a contractual sale restriction would be considered a characteristic of that equity security and, therefore, included within the unit of account. Stakeholders that concluded that a contractual sale restriction was considered in the unit of account measured the fair value of the equity security as the price of an otherwise identical equity security that was not subject to a contractual sale restriction adjusted to reflect the effect of the restriction. Stakeholders asked the Board to clarify the guidance within Topic 820 to resolve the diversity in practice.

BC5. On September 15, 2021, the Board issued proposed Accounting Standards Update, *Fair Value Measurement (Topic 820): Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions,* with comments due on November 14, 2021. The Board received 28 comment letters in response to the amendments in the proposed Update. The Board considered respondents' comments in reaching the conclusions in this Update, as discussed further below.

Costs and Benefits

BC6. The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, donors, and other capital market participants in making rational investment, credit, and similar resource allocation decisions. However, the benefits of providing information for that purpose should justify the related costs. Present and potential investors, creditors, donors, and other users of financial information benefit from improvements in financial reporting, while the costs to implement new guidance are borne primarily by present investors. The Board's assessment of the costs and benefits of issuing new guidance is unavoidably more qualitative than quantitative because there is no method to objectively measure the costs to implement new guidance or to quantify the value of improved information in financial statements.

BC7. In the Board's view, the amendments in this Update clarify and reduce diversity in practice when measuring the fair value of an equity security subject to a contractual sale restriction, which either improves or maintains the decision usefulness of information provided to users of financial information and also improves comparability of financial information across reporting entities.

BC8. The Board does not anticipate that entities will incur significant new costs as a result of applying the amendments in this Update. Some entities will not alter how they currently account for equity securities subject to contractual sale restrictions, while entities that currently incorporate the estimated effects of a contractual sale restriction when measuring the fair value of an equity security may incur some initial costs to update processes and controls. However, the Board noted that those initial costs may be offset by a reduction in the recurring cost and complexity incurred in preparing and auditing the discount incorporated into the fair value measurement. If an investment company currently applies a discount to the market price of an equity security that is subject to a contractual sale restriction, the transition method in this Update requires that the investment company continue to apply the discount until the contractual sale restriction expires or is modified. As a result, an investment company may not see an immediate cost reduction. However, because those contractual sale restrictions are generally short term, the Board does not expect the ongoing retention of operational costs incurred to be significant in most instances. Overall, in the Board's view, the expected benefits of the amendments justify the expected costs.

Basis for Conclusions

Scope

BC9. Initially, the scope of the project that led to the amendments in this Update was limited to equity securities measured at fair value in accordance with Topic 820 and subject to a contractual sale restriction stemming specifically from an underwriter lock-up agreement. Underwriter lock-up agreements are contractual sale restrictions 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. However, contractual arrangements that restrict an entity from selling an equity security are used in many other capital-raising transactions that do not involve an underwritten offering. Those contractual restrictions may be referred to as a lock-up agreement or a market standoff agreement. Alternatively, the restriction could be a provision within a separate agreement between certain shareholders. Examples of those other types of transactions include private placements, private investments in public equity, or a business combination involving a special-purpose acquisition company (SPAC), also referred to as a de-SPAC transaction.

BC10. A majority of the comment letter respondents to the proposed Update supported the proposed scope that would apply to all equity securities subject to any contractual sale restriction. On the basis of that feedback, the Board retained the broader scope. The Board concluded that it would be arbitrary to limit the scope of the project to a restriction from an underwriter lock-up agreement while not including other similar transactions that use contractual sale restrictions. The Board also observed that the amendments in this Update are not limited only to equity securities with active markets (that is, Level 1 equity securities). In the Board's view, there is no basis for concluding that a contractual sale restriction should be viewed differently when measuring fair value in accordance with Topic 820 because of the valuation technique applied by a reporting entity. The amendments in this Update do not change the application of measurement guidance from other Topics, such as Topic 718, Compensation—Stock Compensation.

Measurement

BC11. In the proposed Update, the Board determined that the unit of account when measuring the fair value of an equity security is the individual equity security. 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 that unit of account and, therefore, is not permitted in fair value measurements. The Board considered but rejected alternatives that would have either required a reporting entity to incorporate the effects of a restriction into the fair value of the equity security or required separate recognition and measurement of the contractual sale restriction as a contra-asset or separate liability.

BC12. Comment letter feedback was mixed and lacked consensus within the same industry or stakeholder group. Stakeholders that supported the amendments in the proposed Update emphasized that the benefits of the proposed amendments would be improved consistency and comparability in fair value measurements across reporting entities as well as reduced cost and complexity associated with estimating the effects of the restriction. Most opponents of the proposed amendments acknowledged that a contractual sale restriction was not a characteristic of the equity security but stated that investors would consider recognition and measurement of the contractual sale restriction (whether as a part of the equity security or on its own) decision useful. Those stakeholders also stated that the costs and complexity of estimating the effects of the restriction on the fair value of an equity security were justified to faithfully represent the liquidity and volatility risks that a reporting entity is subject to. Several stakeholders highlighted that investment companies and other entities that measure investments at fair value on a recurring basis and issue financial statements that are consistent with the measurement principles in Topic 946 should be required to incorporate certain contractual restrictions in measuring fair value of equity securities in accordance with specialized industry guidance. Those stakeholders reasoned that the existing specialized industry accounting is designed around the importance of reported net asset value (NAV), which may affect transactions with investors and asset-based fees.

BC13. The Board acknowledges that (a) a reporting entity's inability to sell an equity security for a period of time exposes the reporting entity to the risk that the price of the equity security may decline and (b) the reporting entity would not be able to sell the investment to avoid additional losses. However, the Board observes that those are entity-specific risks that may occur as a result of entering into the contractual sale restriction, which does not affect the fair value of the security itself on the measurement date. As stated in Topic 820, an entity must be able to access the market; it does not need to be able to sell an asset on the measurement date to measure fair value of the asset on the basis of the price in that market. In addition, the Board considered that changing the existing fair value measurement requirement in Topic 820 related to equity securities with contractual sale restrictions could result in a reporting entity applying discounts inappropriately when measuring the fair value of other assets or liabilities and would be inconsistent with decisions made by the Board, such as in Accounting Standards Update No. 2020-07, *Not-for-Profit Entities (Topic 958): Presentation and Disclosures by Not-for-Profit Entities for Contributed Nonfinancial Assets*.

BC14. The Board considered stakeholder feedback that disagreed with the amendments in the proposed Update but noted that those stakeholders did not demonstrate how a contractual sale restriction was a characteristic of the asset;

rather, those stakeholders indicated that they do not agree with the outcomes of applying the principles of Topic 820. On the basis of those factors, the Board affirmed its decision to consider the unit of account as the individual equity security. The Board also decided that a reporting entity is prohibited from recognizing the contractual sale restriction as part of a separate unit of account. The amendments in this Update clarify the application of those principles to equity securities, rather than to change those principles.

BC15. The Board considered but rejected an alternative that would have created specialized guidance for investment companies (and other similar entities) that would have resulted in those entities incorporating the effects of contractual sale restrictions, while other types of entities would not incorporate those effects. The Board decided that it did not want to introduce industry-specific definitions of fair value because the nature of the entity should not change fair value from the perspective of market participants.

BC16. The Board introduced the term *restricted security* in the proposed Update to clarify the fact pattern described in the illustrative example. In comment letter feedback, stakeholders stated that the term *restricted security* was confusing and that it could imply that the effects of a restriction on the sale of an equity security are only incorporated if the definition of a restricted security is met. The Board's intent was not to establish a singular type of restriction that may affect the fair value of an equity security, but rather to clarify why the nature of the restriction is considered a characteristic of the asset and why a contractual sale restriction is not. Therefore, the term was removed from the amendments in this Update and the factors that are relevant are described within the example. The Board observed that the amendments are not intended to change the guidance on the recognition and measurement of contractual arrangements accounted for under other Topics or Subtopics of the Codification as a separate unit of account.

Disclosure

BC17. The Board observed that providing additional information to financial statement users to help them understand liquidity risks associated with an investment in an equity security with a contractual sale restriction would be decision useful. A majority of the comment letter respondents agreed that qualitative and quantitative disclosures would help users better understand the effects of a contractual sale restriction. On the basis of that feedback, the Board decided to require the following disclosures for equity securities subject to contractual sale restrictions:

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

BC18. The Board decided that equity securities restricted from sale because they are pledged as collateral and included in other disclosures required by other Topics should not be included in the information required in paragraphs BC17(a) through (c).

BC19. The Board decided that a reporting entity should consider the guidance in paragraph 820-10-50-1D when disclosing the information required by the amendments in this Update, including how much aggregation or disaggregation to undertake when disclosing that information. A reporting entity may have multiple investments in equity securities subject to contractual sale restrictions, none of which are individually material or have distinct features that affect the nature or remaining duration of the restrictions. In that case, the reporting entity may decide to disclose the information required by the amendments in the aggregate. Alternatively, the Board decided that if one or a number of investments in equity securities were individually material or had distinct features that would affect the nature or remaining duration of the restriction, a financial statement user may consider more disaggregated information to be decision useful.

Effective Date and Transition

BC20. For public business entities, the Board decided that the amendments in this Update 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.

BC21. The Board decided that all entities, except entities that meet the definition of an investment company under Topic 946, should apply the amendments in this Update prospectively to all equity securities. Any adjustment as a result of applying the amendments should be recognized in earnings on the date of adoption and the amount of that adjustment should be disclosed in the period that the entity first applies the amendments. The Board observed that prospective application applies to the initial and subsequent measurement of fair value in accordance with Topic 820 when the measurement date is on or after the date of adoption. An entity should not revise the carrying amount of an asset or a liability that was previously measured at fair value on a nonrecurring basis if the measurement date occurs before the date of adoption.

BC22. Investment companies should apply the amendments in this Update to an equity security that becomes subject to a contractual sale restriction (or when an existing contractual restriction is modified) on or after the date of adoption. For an equity security that becomes subject to a contractual sale restriction before the date of adoption, the investment company should continue to account for that equity security using the accounting policy applied before the adoption of the amendments until the contractual restriction expires or is modified.

BC23. The Board decided that investment companies should have specialized transition guidance because of the direct effect that the amendments in this Update will have on the computation of NAV. The Board wanted to avoid introducing non-market-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. The Board considered but rejected a retrospective or modified retrospective transition approach because those transition methods would introduce both complexity and operability challenges related to recalculating NAV or management fees. A majority of the comment letter respondents to the proposed Update supported the specialized transition guidance for investment companies.

Amendments to the GAAP Taxonomy

The amendments to the *FASB Accounting Standards Codification*® in this Accounting Standards Update require improvements to the GAAP Financial Reporting Taxonomy and SEC Reporting Taxonomy (collectively referred to as the "GAAP Taxonomy"). Those improvements, which will be incorporated into the proposed 2023 GAAP Taxonomy, are available through GAAP Taxonomy Improvements provided at www.fasb.org, and finalized as part of the annual release process.