Grant Thornton

Snapshot

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Equity securities subject to contractual sale restrictions

To reduce diversity in practice, the FASB recently issued ASU 2022-03, *Fair Value Measurement (Topic 820) – Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions,* which stipulates that a contractual restriction on the sale of an equity security should not be considered part of the equity security's unit of account and, therefore, should not be considered in measuring its fair value.

An example of a contractual sale restriction is a lock-up agreement, also referred to as a "market standoff agreement," which is a contract between underwriters and other insiders of an entity during its initial public offering that prohibits these parties from selling any of their equity securities in the entity for a stated period of time.

Fair value measurement

Fair value, as defined in ASC 820, is the price that would be received either to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

The guidance in ASC 820 states that when measuring the fair value of an asset, a reporting entity should consider the characteristics of the asset, including any sale restrictions, if a market participant would also take those characteristics into account when determining fair value. An important determination in identifying the characteristics *of the asset* is identifying the appropriate unit of account.

Prior to ASU 2022-03, reporting entities that did not reflect the contractual sale restriction in the fair value measurement of the equity security referred to ASC 820-10-35-36B, which states that certain discounts or premiums that reflect a characteristic such as the size of the reporting entity's holding, rather than a characteristic of the asset, are not permitted in calculating the fair value measurement. Conversely, reporting entities that reflected the contractual sale restriction in the fair value measurement of the equity security pointed to an illustrative example that stated this restriction is a characteristic of the instrument that would transfer to a market participant and, therefore, should be reflected in the instrument's fair value. ASU 2022-03 amends the illustrative example so that this example now aligns with the guidance in ASC 820-10-35-36B, thereby reducing such diversity in practice.

Equity securities with contractual sale restrictions

The amendments in ASU 2022-03 specify that a contractual sale restriction is a restriction that is attributable to the holding entity, not to the security itself, so the contractual sale restriction does not impact the fair value measurement of the equity security. As a result, an entity is required to measure the fair value of an equity security subject to any contractual sale restriction on the basis of the market price of the same equity security without a contractual sale restriction (that is, without adjusting the basis to reflect the holder's inability to sell the equity security on the measurement date).

In addition, the guidance in ASU 2022-03 clarifies that an entity should not recognize a contractual sale restriction as a separate unit of account.

Restricted securities

The amendments in ASU 2022-03 do not change the guidance for equity securities subject to legal restrictions that prevent the securities from being sold on a national securities exchange or an over-the-counter (OTC) market until the securities are registered or deemed to be exempt from registration (for example, equity securities held following a private placement transaction involving an issuer whose shares were also sold on a national securities exchange or an OTC market). A holder of equity securities subject to these legal restrictions must consider the impact of the restriction in the fair value measurement of the equity securities.

A legal restriction differs from a contractual sale restriction because *any* holder of the equity securities subject to such restriction is not able to access certain markets where the equity securities are sold until the securities are either registered or deemed to be exempt from registration. Therefore, unlike a contractual sale restriction, the legal restriction is a characteristic of the asset.

Disclosures

The amendments require an entity to disclose the following information for equity securities subject to contractual sale restrictions (except for equity securities restricted from sale because they are pledged as collateral and included in other disclosures):

- The nature and remaining duration of the contractual sale restriction
- The circumstances that could cause a lapse in the contractual sale restriction
- The fair value of equity securities subject to contractual sale restrictions reflected on the balance sheet

Effective date and transition

For public business entities, the amendments are effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years.

For all other entities, the amendments are effective for fiscal years beginning after December 15, 2024, including interim periods within those fiscal years.

Early adoption is permitted for both interim and annual financial statements that have not yet been issued or been made available for issuance.

Transition – All entities (except investment companies)

All entities, except investment companies within the scope of ASC 946, should apply the amendments in ASU 2022-03 on a prospective basis. Any adjustments to a security's fair value as a result of applying the amendments should be recognized as an adjustment to current-period earnings on the date of initial application and disclosed in the notes.

Transition – Investment companies (ASC 946)

An investment company within the scope of ASC 946 should apply the amendments in ASU 2022-03 on a prospective basis to an equity security that becomes subject to a contractual sale restriction (or to an existing contractual restriction that is modified) on or after the date of initial application.

An investment company should continue to apply its previous measurement approach to equity securities subject to a contractual sale restriction that has been executed before the date of initial application, until that contractual sale restriction either expires or is modified.

Any adjustments to the fair value measurement as a result of a modification of a contractual sale restriction should be recognized as an adjustment to current-period earnings in the period when the modification occurs.

An investment company that continues to apply a discount to measure the fair value of equity securities subject to a contractual sale restriction executed before adopting the amendments in ASU 2022-03 should disclose the following information until that contractual sale restriction either expires or is modified:

- The fair value of equity securities subject to a contractual sale restriction to which the investment company applies a discount
- The nature and remaining duration of the contractual sale restriction
- The circumstances that could cause a lapse in the restriction

The equity securities included in these disclosures are excluded from the amounts and qualitative information disclosed for equity securities measured in accordance with the amendments in ASU 2022-03.

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