Prepared for New Fair Value Guidance for Restricted Equity Securities?

Historically, there has been diversity in practice on how an equity security's contractual restriction impacts its fair value measurement (FVM). On June 30, 2022, FASB issued Accounting Standards Update (ASU) 2022-03, *Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions*, which clarifies that a contractual restriction on the sale of an equity security is not considered part of the security's unit of account and should not be considered in measuring fair value. Entities also are now prohibited from recognizing and measuring the contractual sales restriction as a separate unit of account, *e.g.*, as a liability or contra-asset. The ASU also adds new disclosures for these restricted investments.

Early adoption is permitted and special transition provisions have been provided for investment companies.

Effective Dates ASU 2022-03	PBEs	All Others
	• Fiscal years beginning after December 15, 2023, including interim periods	• Fiscal years beginning after December 15, 2024, including interim periods

Contact a professional at **FORVIS** today to see if early adoption makes sense for your company.

Background

Diversity in measuring the fair value of an equity investment with a sale restriction arises from the interpretation of the unit of account. Is the sale restriction an attribute of the security or the owner of the security? Those who consider the equity security and the restriction a single unit of account measure the fair value as the price of an otherwise identical security without a restriction and then make a price adjustment for the restriction. Those who feel the restriction applies only to the security holder measure a security with a sales restriction as the price of an otherwise identical security without a restriction (no price adjustment is made for the restriction).

FASB concluded a contractual sale restriction only affects the behavior of the equity holder and does not affect the security itself. The restriction is an entity-specific characteristic, and this ASU cleans up ambiguous language and a previous illustrative example in Accounting Standards Codification (ASC) 820, *Fair Value Measurement.*

This topic was hotly debated with a close four to three vote for approval. The dissenting board members felt that contractual sale restrictions have economic substance affecting the holder's ability to realize value from the security, and that substance should not be disregarded for accounting purposes.

The ASU does not change any of the existing principles of fair value measurement.

Scope

The ASU applies to all equity securities subject to any contractual sales restriction. Common examples include, but are not limited to:

- Underwriter lock-up agreements – Contractual sale restrictions typically executed with an initial or secondary public offering to prohibit the sale of equity securities owned by certain investors for a specified period
- Market standoff agreement – A legal contract that prevents company insiders from selling their shares in

- the company on the stock market for a certain period of time following an initial public offering
- A provision within a broad shareholder's agreement
- Private investments in public equity or a business combination involving a special-purpose acquisition company

A contractual sale restriction is distinct from a regulatory sale restriction[1]. Regulatorily restricted securities and contractually restricted securities are transacted in different markets—that is, in a hypothetical sale, a regulatorily restricted security can only be sold in a market separate from either the national securities exchange or an over-the-counter (OTC) market in which the registered equity securities are sold. The inability to sell the restricted security either on the national securities exchange or an OTC market does not differ on the basis of which entity holds the security, thus making the restriction a characteristic of the asset rather than a characteristic of the entity holding that asset.

Disclosures

The following disclosures are required for equity securities subject to contractual sale restrictions:

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

Entities with multiple equity security investments subject to sales restrictions will need to use judgment on the disclosure level detail. If sale restrictions are not individually material or do not have distinct features that affect the restriction's nature or remaining duration, an entity may decide to aggregate the required disclosure information. However, if one or a number of equity security investments are individually material or have distinct features that affect the restriction's nature or remaining duration, disaggregated information would make sense for financial statement presentation.

These disclosures do not apply to restrictions arising from pledging securities as collateral.

Effective Date & Transition

ASU 2022-03 will be effective for public business entities (PBE) for fiscal years beginning after December 15, 2023, including interim periods therein, with early adoption permitted. All other entities would be required to adopt this ASU for fiscal years beginning after December 15, 2024 and interim periods therein. Early adoption is permitted for both interim and annual financial statements that have not yet been issued (or made available for issuance).

For entities other than investment companies—as defined under ASC 946, *Financial Services—Investment Companies*—the ASU would be applied prospectively as an adjustment to current-period earnings on the date at which the entity first applies the new guidance, with any adjustments recognized in earnings. The entity will disclose the amount recognized as an adjustment to earnings in the period the entity first applies the measurement guidance.

Since these changes will impact the computation of net asset values, FASB has specialized transition guidance for investment companies. These changes would only apply to an equity security investment if the contractual arrangement restricting the sale is executed or modified on or after the adoption date.

An investment company that was incorporating the effects of the restriction in fair value measurement prior to the effective date would continue to do so. That is, an investment company with an equity security with a restriction in place before the adoption date would continue to account for the equity security until the contractual restriction expires or is modified using the company's pre-adoption accounting policy. An investment company that continues to apply a discount to an equity security due to a pre-adoption restriction would need to include the three disclosures above for each period the discount is applied.

Conclusion

If you have questions about these changes, contact a professional at FORVIS today.

Contributors

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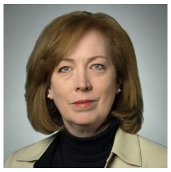

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[1] *An equity security that is not registered for sale with a national securities exchange or an OTC market, either domestic or foreign, when other equity securities from the same class of stock are registered for sale with a national securities exchange or an OTC market. To be legally sold on a national securities exchange or an OTC market, the unregistered security must be registered or satisfy the conditions necessary for an exemption from registration. An equity security is no longer considered a restricted security if the conditions necessary for an exemption from registration have been met even if the security remains unregistered.*