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FASB Clarifies Fair Value Measurement Guidance

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Introduction

On June 30, 2022, the FASB issued [ASU 2022-03](#),¹ which (1) clarifies the guidance in ASC 820² on the fair value measurement of an [equity security](#) that is subject to a contractual sale restriction and (2) requires specific disclosures related to such an equity security.

Under current guidance, stakeholders have observed diversity in practice related to whether contractual sale restrictions should be considered in the measurement of the fair value of equity securities that are subject to such restrictions. On the basis of interpretations of existing guidance and the current illustrative example in ASC 820-10-55-52 (Example 6, Case A) of a restriction on the sale of an equity instrument, some entities use a discount for contractual sale restrictions when measuring fair value, while others view the application of such a discount to be inconsistent with the principles of ASC 820. To reduce the diversity in practice and increase the comparability of reported financial information, ASU 2022-03 clarifies this guidance and amends the illustrative example.

Main Provisions of ASU 2022-03

ASU 2022-03 clarifies that a “contractual sale restriction prohibiting the sale of an equity security is a characteristic of the reporting entity holding the equity security” and is not included in the equity security’s unit of account. Accordingly, an entity should not consider the contractual sale restriction when measuring the equity security’s fair value (i.e., the entity should not apply a discount related to the contractual sale restriction, as stated in ASC 820-10-

¹ FASB Accounting Standards Update (ASU) No. 2022-03, *Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions*.

² FASB Accounting Standards Codification (ASC) Topic 820, *Fair Value Measurement*.

35-36B as amended by the ASU). In addition, the ASU prohibits an entity from recognizing a contractual sale restriction as a separate unit of account.

Under the existing guidance in ASC 820-10-35-6B, “[a]lthough 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.” ASU 2022-03 clarifies that an entity should apply this existing guidance when measuring the fair value of equity securities that are subject to contractual sale restrictions (i.e., a contractual sale restriction on the reporting entity that prevents the sale of an equity security in the market does not prevent the entity from measuring the fair value of the equity security on the basis of the price in that principal market).

In addition, ASU 2022-03 amends the implementation guidance in ASC 820-10-55-51, as well as the fact pattern in Example 6, Case A (by amending ASC 820-10-55-52 and adding ASC 820-10-55-52A), to illustrate whether and, if so, when an entity should consider a sale restriction in measuring fair value.



Connecting the Dots

As amended by ASU 2022-03, Example 6, Case A, notes that when measuring fair value, an entity should:

- Consider sale restrictions that are characteristics of the equity security (e.g., a restriction resulting from a security that is not registered for sale with a national securities exchange or an over-the-counter market when other securities from the same class of stock are registered for sale).
- Not consider sale restrictions that are characteristics of the holder of the equity security (e.g., a lock-up agreement, a market stand-off agreement, or a sale restriction provision within an agreement between certain shareholders).

Further, ASU 2022-03 requires specific disclosures related to equity securities that are subject to contractual sale restrictions, including (1) the fair value of such equity securities reflected in the balance sheet, (2) the nature and remaining duration of the corresponding restrictions, and (3) any circumstances that could cause a lapse in the restrictions.

The amendments in ASU 2022-03 are consistent with the principles of fair value measurement under which an entity is required to consider characteristics of an asset or liability if other market participants would also consider those characteristics when pricing the asset or liability. Specifically, the ASU clarifies that an entity should apply these fair value measurement principles to equity securities that are subject to contractual sale restrictions.

Effective Dates and Transition

Effective Dates

ASU 2022-03's amendments are effective as follows:

- For public business entities, fiscal years beginning after December 15, 2023, and interim periods within those fiscal years, with early adoption permitted.
- For all other entities, fiscal years beginning after December 15, 2024, and interim periods within those fiscal years, with early adoption permitted for both interim and annual financial statements that have not yet been issued or made available for issuance.

Transition

For investment companies as defined in ASC 946, the amendments in ASU 2022-03 should be applied to equity securities with a contract containing a sale restriction that is executed or modified on or after the adoption date. For equity securities with a contract containing a sale restriction that was executed before the adoption date, investment companies should continue to apply the historical accounting policy for measuring such securities until the contractual restriction expires or is modified. If the historical accounting policy includes applying a discount to equity securities that are subject to contractual sale restrictions, investment companies should disclose in each period, until the contractual restrictions expire or are modified, (1) the fair value of such equity securities executed before the adoption date to which the entity continues to apply a discount, (2) the nature and remaining duration of the contractual sale restrictions, and (3) the circumstances that could cause a lapse in the restrictions.

All entities other than investment companies as defined in ASC 946 should apply the amendments in ASU 2022-03 prospectively and recognize in earnings on the adoption date any adjustments made as a result of adoption.

Appendix — Definition of Equity Security

ASU 2022-03 adds to the ASC 820-10 glossary the following definition of an equity security from the ASC master glossary:

ASC Master Glossary
<p>Equity Security (first definition)</p> <p>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:</p> <ul style="list-style-type: none">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.

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