Clarity on Fair Value – A Practical Approach to Restricted Securities

Key Aspects of ASU 2022-03:

ASU 2022-03 Fair Value Measurements (Topic 820) clarifies that contractual sale restrictions should not be considered in measuring the fair value of equity securities. As noted in ASU 2022-03, holder specific restrictions are disregarded from fair value measurement because the restriction is tied to the reporting entity holding the security and not the security itself. An example of a holder specific restriction is a lock-up agreement. A lock-up agreement is not considered to be a characteristic of the asset, since it restricts holders from selling their company shares for a specific period after an initial public offering. Therefore, this type of restriction should not be considered when measuring fair value of the equity security under topic 820. Also, no discount should be applied to the fair value of the equity security simply because of a contractual sale restriction.

Situational Example #1 – Holder Specific Restrictions:

Company A holds 10,000 shares of Company B, a publicly traded entity. These shares are subject to a one-year lock-up agreement following a private placement. As a result, Company A cannot sell the shares for one year. The shares are identical to Company B's unrestricted shares, which trade at $50 per share as of the date of measurement.

How should these shares be valued?
Under ASC 2022-03, Company A must measure the fair value of its 10,000 shares at the quoted price of $50 per share, without applying a discount for the one-year lock-up restriction. The fair value is $500,000 (10,000 x $50), regardless of the restriction.

A common example of a restriction inherent to a security is when an investor acquires shares through a private placement that are not registered for public trading. The shares are subject to legal or regulatory restrictions such as the Securities Act Rule 144, which imposes a minimum holding period (six months, one year, etc.) before the investor can sell the securities in the public market. This restriction is inseparable from the security and applies to any holder, not just the initial investor.

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Situational Example #2 – Shares Acquired through Private Placement Regulatory Restriction:

Company C acquires 5,000 shares of Company D through a private placement. The shares are not registered for public trading and are subject to a one-year Rule 144 holding period; therefore, the shares cannot be sold in the public market for at least one year. The identical unrestricted shares of Company D trade at $40 per share on a national exchange.

How should these shares be valued?
Under ASC 2022-03, Company C must adjust the quoted price of the unrestricted shares to reflect the impact of the restriction when measuring fair value because the restriction is inherent to the security. The fair value of the restricted shares will generally be less than $200,000 (5,000 x $40) due to the reduced liquidity and marketability caused by the one-year restriction.

Required Disclosures:

- Disclose the fair value of the equity securities that are subject to contractual sales restrictions.
- Disclose the nature and remaining duration of the restrictions.
- Disclose the circumstances that could cause a lapse in the restrictions.
- In the period of adoption, disclose the amount recognized as an adjustment to earnings (or changes in net assets for nonprofits) as a result of applying ASU 2022-03.

Summary:

ASU 2022-03 is effective for fiscal years beginning after December 15, 2024, with prospective application and required disclosure of any adoption-related adjustments. The ASU prohibits discounts for contractual sale restrictions in fair value measurement of equity securities and requires new disclosures about the fair value, nature, duration, and lapse conditions of such restrictions.