FASB EXPOSURE DRAFT

*Proposed Accounting Standards Update*

Issued: September 15, 2021
Comments Due: November 14, 2021

# Fair Value Measurement (Topic 820)

## Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions

The Board issued this Exposure Draft to solicit public comment on proposed changes to Topic 820 of the *FASB Accounting Standards Codification*®. Individuals can submit comments in one of three ways: using the electronic feedback form on the FASB website, emailing comments to director@fasb.org, or sending a letter to "Technical Director, File Reference No. 2021-005, FASB, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116."

Financial Accounting Standards Board

**Notice to Recipients of This Exposure Draft of a Proposed Accounting Standards Update**

The Board invites comments on all matters in this Exposure Draft until November 14, 2021. Interested parties may submit comments in one of three ways:

- Using the electronic feedback form available on the FASB website at Exposure Documents Open for Comment
- Emailing comments to director@fasb.org, File Reference No. 2021-005
- Sending a letter to "Technical Director, File Reference No. 2021-005, FASB, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116."

All comments received are part of the FASB's public file and are available at www.fasb.org.

The *FASB Accounting Standards Codification*® is the source of authoritative generally accepted accounting principles (GAAP) recognized by the FASB to be applied by nongovernmental entities. An Accounting Standards Update is not authoritative; rather, it is a document that communicates how the Accounting Standards Codification is being amended. It also provides other information to help a user of GAAP understand how and why GAAP is changing and when the changes will be effective. A copy of this Exposure Draft is available at www.fasb.org.



FASB FINANCIAL ACCOUNTING STANDARDS BOARD®

# Proposed Accounting Standards Update

# Fair Value Measurement (Topic 820)

# Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions

September 15, 2021

Comment Deadline: November 14, 2021

## CONTENTS

# Summary and Questions for Respondents

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

The FASB is issuing this proposed Update to clarify the guidance in Topic 820, Fair Value Measurement, on measuring the fair value of an equity security and to amend an example that addresses contractual restrictions that prohibit the sale of an equity security.

Stakeholders have asserted that because of the language in the illustrative example, there is 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 identical equity security that is not 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 Would Be Affected by the Amendments in This Proposed Update?

The amendments in this proposed Update would affect all entities that have investments in equity securities measured at fair value that are subject to contractual restrictions preventing the sale of those securities.

## What Are the Main Provisions?

The amendments in this proposed Update would 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.

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

The amendments in this proposed Update would not change the principles of fair value measurement. The proposed amendments would clarify 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 Would the Amendments Be Effective and What Are the Transition Requirements?

The effective date will be determined after the Board considers stakeholder feedback on the amendments in this proposed Update.

For all entities except investment companies as defined under Topic 946, Financial Services—Investment Companies, the amendments in this proposed Update would be applied prospectively with any adjustments from the adoption of the proposed amendments recognized in earnings on the date of adoption.

An entity that qualifies as an investment company under Topic 946 would only apply the amendments in this proposed Update to an investment in an equity security in which the contractual arrangement that restricts the sale of the equity security is executed or modified *on* or *after* the adoption date. An equity security in which the contractual arrangement that restricts the sale of the equity security was executed *before* the adoption date would 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 proposed 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).

## Questions for Respondents

The Board invites individuals and organizations to comment on all matters in this proposed Update, particularly on the issues and questions below. Comments are requested from those who agree with the proposed guidance as well as from those who do not agree. Comments are most helpful if they identify and clearly explain the issue or question to which they relate. Those who disagree with the proposed guidance are asked to describe their suggested alternatives, supported by specific reasoning.

**Question 1—Restriction Type:** Do you agree with the Board's decision on scope to include all contractual restrictions that prohibit the sale of an equity security? Please explain why or why not.

**Question 2—Measurement:** Do you agree with the Board's decision that a contractual restriction prohibiting the sale of an equity security is not considered part of the unit of account of the equity security and, therefore, should not be considered in measuring fair value? Alternatively, should the Board amend the guidance in Topic 820 (or elsewhere in GAAP) such that contractual sale restrictions would be required to be considered in determining fair value?

**Question 3—Entity Type:** Should all types of entities use the same unit of account when measuring the fair value of an equity security subject to a contractual sale restriction, or should certain types of entities (for example, investment companies, broker dealers, and pension plan financial statements) have a different unit of account? Please explain your response.

**Question 4—Disclosures:** Would qualitative or quantitative disclosures (for example, describing the nature of a contractual sale restriction on an equity security and the related amount recognized on the balance sheet) help users in understanding the effects of a contractual restriction on the sale of an equity security held by a reporting entity? Please explain why or why not. For reporting entities, what costs would be incurred to disclose that information?

**Question 5—Transition:** Do you agree with the transition guidance in this proposed Update? Please explain why or why not.

**Question 6—Implementation:** How much time would be necessary to implement the proposed amendments? Should the amount of time needed to implement the proposed amendments by entities other than public business entities be different from the amount of time needed by public business entities? Please explain your response.

**Question 7—Clarity and Operability:** Do you agree that the proposed amendments and, in particular, the definition of a restricted security provide the necessary clarity to resolve existing diversity in practice? Please explain why or why not. Are the proposed amendments operable and auditable? If not, which proposed amendment or amendments pose operability or auditability issues and why?

# Amendments to the *FASB Accounting Standards Codification*®

## Introduction

1. The Accounting Standards Codification is amended as described in paragraphs 2–5. 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 underlined, and deleted text is ~~struck out~~.

## Amendments to Master Glossary

2. Add the new Master Glossary term *Restricted Security*, with a link to transition paragraph 820-10-65-13, as follows:

**Restricted Security**

An **{add glossary link to 1st definition}equity security{add glossary link to 1st definition}** that is not registered for sale with a national securities exchange or an over-the-counter 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 over-the-counter market. To be legally sold on a national securities exchange or an over-the-counter 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.

3. 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 Topic 820

4. Amend paragraphs 820-10-35-6B, 820-10-35-36B, and 820-10-55-51 through 55-52 and the related heading and add paragraph 820-10-55-52A, 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 is subject to a contractual restriction that prevents the sale of the equity security does not prevent an entity from measuring fair value on the basis of the price in that market. Rather, an entity must measure fair value on the basis of the price in that market based on the value of the same equity security that is not subject to a contractual sales restriction (see paragraphs 820-10-55-52 through 55-52A).

**> 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 that reflects a contractual restriction preventing the sale of an equity security is inconsistent with the unit of account being the equity security. A contractual restriction is a characteristic of the reporting entity holding the equity security rather than a characteristic of the asset and is not permitted in measuring the fair value of an equity security (see paragraphs 820-10-55-52 through 55-52A). 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.

## 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 is included within the unit of account of the asset and would be taken into account by market participants when pricing 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**

**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.~~A reporting entity holds a **restricted security**. A restricted security cannot be sold on a national securities exchange or an over-the-counter market; therefore, it is considered similar but not identical to an **{add glossary link to 1st definition}equity security{add glossary link to 1st definition}** of the same class that is registered for sale on a national securities exchange or an over-the-counter market. Because a restricted security remains ineligible for sale on a national securities exchange or an over-the-counter market until either the share is registered or it meets the conditions necessary for an exemption from registration, the sale would occur in a different market on the measurement date. Because a market participant would consider the inability to resell the restricted security in a national securities exchange or an over-the-counter market when pricing the equity security, the reporting entity would consider that restriction a characteristic of the asset. In that case, the reporting entity should measure the fair value of the restricted 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 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.

**820-10-55-52A** A reporting entity holds an equity security that is not also considered a restricted security (see paragraph 820-10-55-52) subject to a contractual restriction that prohibits sale of the equity security by the reporting entity. A contractual restriction 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 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 a characteristic of the asset and is ignored. The equity security subject to the contractual restriction is identical to an equity security of the same class that is not subject to a contractual 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 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.

5. 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. 2021-XX, *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. 2021-XX, *Fair Value Measurement (Topic 820): Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions:*

a. The pending content that links to this paragraph shall be effective for all entities for fiscal years beginning after December 15, 202X [date to be inserted after exposure], including interim periods within those fiscal years.
b. An entity shall apply the pending content that links to this paragraph to equity securities 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 shall apply the accounting policy applied before the adoption of the pending content that links to this paragraph to an equity security purchased before the date at which

the investment company first applies the pending content that links to this paragraph that is subject to a contractual restriction that was executed before the date at which the investment company first applies the pending content that links to this paragraph until the contractual restriction expires or is modified. 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 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.

*The amendments in this proposed Update were approved for publication by four members of the Financial Accounting Standards Board. Messrs. Cannon, Jones, and Kroeker voted against publication of the amendments. Their alternative views are set out at the end of the basis for conclusions.*

*Members of the Financial Accounting Standards Board:*

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

# Background Information, Basis for Conclusions, and Alternative Views

## Introduction

BC1. The following summarizes the Board's considerations in reaching the conclusions in this proposed 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 proposed Update to clarify the guidance in Topic 820 on measuring the fair value of an equity security and to amend an example that addresses contractual restrictions that prohibit the sale of an equity security, 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. 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 have 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). 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, an illustrative example within Topic 820 that addresses the consideration of the effects of a restriction on the ability to sell an equity security indicates that a contractual sale restriction would be considered a characteristic of that equity security and, therefore, included within the unit of account. Stakeholders that conclude that a contractual sale restriction is considered in the unit of account measure the fair value of the equity security as the price of an otherwise identical equity security that is not subject to a contractual sale restriction adjusted to reflect the effect of the restriction. Stakeholders have asked the Board to clarify the guidance within Topic 820 to resolve the diversity in practice.

## Benefits and Costs

BC5. 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.

BC6. The Board believes that the amendments in this proposed Update would clarify and reduce diversity in practice in measuring the fair value of an equity security subject to a contractual sale restriction, which would either improve or maintain the decision usefulness of information provided to users of financial information as well as improve comparability of financial information across reporting entities.

BC7. The Board does not anticipate that entities would incur significant costs as a result of applying the amendments in this proposed Update. Some entities would 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 believes that those initial costs would 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 proposed transition method would require that the investment company continue to apply the discount until the contractual restriction expires or is modified. As a result, an investment company may not see an immediate cost reduction. However, because those contractual restrictions are generally short term, the Board does not expect the ongoing retention of operational costs incurred to be significant. Overall, the Board believes that the expected benefits of the proposed amendments would justify the expected costs.

# Basis for Conclusions

## Scope

BC8. Initially, the scope of the project that led to the amendments in this proposed Update was limited to equity securities 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 broad shareholder's agreement. Examples of those other types of transactions include private investments in public equity or a business combination involving a special-purpose acquisition company. The Board decided 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 transactions that use similar contractual sale restrictions.

## Measurement

BC9. The Board determined that the unit of account when measuring an equity security is the individual equity security using the principles of Topic 820. Therefore, 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) would not be consistent with that unit of account and therefore should not be permitted in fair value measurements.

BC10. The Board observed that a contractual sale restriction only affects the behavior of the holder of the equity security and does not affect the security itself and, therefore, is an entity-specific characteristic. The Board recognized that the current guidance in Topic 820 is not sufficiently clear and, therefore, the amendments in this proposed Update would provide the clarification necessary to resolve diversity in practice when applying the guidance within Topic 820 without amending the existing principles of fair value measurement.

BC11. The Board also observed that a contractual sale restriction is distinct from a regulatory sale restriction, which is the type of restriction affecting a restricted security (as that term is defined in the amendments in this proposed Update). For example, 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 the national securities exchange or an over-the-counter market in which the registered equity securities are sold. The inability to sell the restricted security on the national securities exchange or an over-the-counter 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. Therefore, the regulatorily restricted security may be similar—but is not identical—to a freely traded security.

BC12. In contrast, the hypothetical sale of the equity security subject to a contractual sale restriction that is also registered with a national securities exchange or over-the-counter market (or it meets the requirements to be exempt from registration) would have the same market as the same equity security of the same class from the same issuer without a contractual sale restriction. The holder’s inability to sell the contractually restricted security on the national securities exchange or an over-the-counter market is a function of which entity holds the security, thus making the restriction a characteristic of the entity holding that asset rather than a characteristic of the asset. Furthermore, as stated in Topic 820, an entity does not need to be able to sell an asset on the measurement date to measure fair value on the basis of the price in that market. Thus, for purposes of fair value measurement under Topic 820, the Board views an equity security subject to a contractual sale restriction as identical to an equity security of the same class from the same issuer that is not subject to a contractual sale restriction.

BC13. The Board rejected alternatives in which a contractual sale restriction would affect the measurement of fair value of an equity security on the basis that the contractual restriction is a characteristic of the entity holding the equity security and doing so would conflict with the principles of fair value measurement in Topic 820. The Board decided not to change the existing fair value measurement requirement in Topic 820 on entity-specific restrictions for equity securities because those changes could have unintended consequences on measuring the fair value of other assets or liabilities. Thus, the objective of this project is to clarify the application of those principles to equity securities, rather than to change those principles.

## Effective Date and Transition

BC14. The Board did not propose an effective date for the amendments in this proposed Update or decide on the ability to early adopt the proposed amendments. Consequently, the Board will consider the comments received on the proposed amendments before determining when those proposed amendments would be effective and whether to permit early adoption.

BC15. 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 proposed Update prospectively to all equity securities. Any adjustment as a result of applying the proposed amendments would be recognized in earnings on the date of adoption.

BC16. Investment companies would apply the amendments in this proposed 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 would continue to account for that equity security using the accounting policy applied before the adoption of the proposed amendments until the contractual restriction expires or is modified.

BC17. The Board decided that investment companies should have specialized transition guidance because of the direct effect that the amendments in this proposed Update would have on the computation of net asset values. 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 proposed amendments to all equity securities on the date of adoption. The Board considered and rejected investment companies applying a retrospective or modified retrospective transition approach because those transition methods would introduce both complexity and operability challenges related to recalculating net asset values or management fees.

## Alternative Views

BC18. Messrs. Cannon, Jones, and Kroeker do not support the conclusion in this proposed Update that would preclude all entities from incorporating the effects of an entity-specific 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 arbitrary from an economic point of view because the value of an equity security can typically only be fully realized through sale. Furthermore, in that case, the distinction is not particularly meaningful because the restriction precludes transfer of the asset and, thus, a determination of whether the restriction would transfer with a sale of the equity security is only hypothetical.

BC19. Consistent with research performed in the development of this proposed Update, Messrs. Cannon, Jones, and Kroeker note that restrictions on sale because of underwriter lock ups (and other similar contractual sale restrictions) are often 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 this 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.

BC20. 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 proposed Update would 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 the 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 in this proposed Update as a "restricted security."

BC21. 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.

BC22. In the view of Messrs. Cannon, Jones, and Kroeker, systematically overstating the *accounting* fair value of equity securities subject to contractual sales 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), this proposed conclusion has the potential to result in excess compensation to investment managers and may result in less meaningful reporting of investment company performance.

BC23. An issue similar to the one noted in paragraph BC22 was addressed by the U.S. Securities and Exchange Commission (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:

a. 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.
b. 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.
c. 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.

BC24. 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. [page 2]

BC25. Accordingly, while Messrs. Cannon, Jones, and Kroeker do not support the conclusion in this proposed Update, they do support an alternative approach that would incorporate the effects of contractual sale restrictions (other than in connection with the equity securities being pledged as collateral) in determining fair value. They believe that incorporating the risks imposed by the sale restrictions would provide information that financial statement users would consider relevant and decision useful.

BC26. Furthermore, in the case of investment companies, Messrs. Cannon, Jones, and Kroeker believe that the risks imposed by the restrictions directly affect the economics of transactions with investors. They support an approach that would amend Topic 820 (specifically to address the types of restrictions within the scope of the amendments in this proposed Update) or that would amend Topic 321, Investments—Equity Securities, to change the unit of account from an individual equity security and require that the unit of account comprise both the equity security and a contractual sale restriction agreement (if one exists). That would result in the de facto conclusion that a contractual sale restriction must be combined with an equity security for purposes of determining fair value. Messrs. Cannon, Jones, and Kroeker support that approach for all entities. However, if preserving the unit of account under Topic 820 were determined to be essential and an amendment to Topic 321 is not warranted, it is not clear that the same accounting outcome is appropriate 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”).

BC27. Thus, alternatively, Messrs. Cannon, Jones, and Kroeker could possibly 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 on the balance sheet (but possibly combined with the underlying investment for reporting purposes) and measured at fair value, consistent with the reporting of all investments at fair value.

# Amendments to the GAAP Taxonomy

The provisions of this Exposure Draft, if finalized as proposed, would require improvements to the GAAP Financial Reporting Taxonomy and SEC Reporting Taxonomy (collectively referred to as the "GAAP Taxonomy"). We welcome comments on these proposed improvements to the GAAP Taxonomy at xbrled@fasb.org. After the FASB has completed its deliberations and issued a final Accounting Standards Update, the proposed improvements to the GAAP Taxonomy will be finalized as part of the annual release process.