Frawley & Co.
CERTIFIED PUBLIC ACCOUNTANT

November 14, 2021

FASB Technical Director
401 Merritt, PO Box 5116
Norwalk, CT 06856-5116

Via e-mail: director@fasb.org

Re: Proposed Accounting Standards Update: *Fair Value Measurement (Topic 820) – Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions*

Dear Technical Director:

Frawley & Co. PLLC ("Frawley & Co.," "we," "our") respectfully submits our comments on the referenced proposed Accounting Standards Update ("ASU"). Frawley & Co. is a boutique, certified public accounting firm, based in Miami, Florida, that offers specialized accounting, advisory and valuation services to both public and other than public business entities.

On Monday, November 2, 2020, we participated in public outreach for the proposed ASU with a Practice Fellow from the FASB (the "Public Outreach") regarding an article we had written, published in the August 2020 edition *of BVU* (Business Valuation Update), concerning a disagreement between the valuation specialist and independent auditors on the fair value of equity securities issued as consideration in a merger transaction involving a special-purpose acquisition company (SPAC) in which we provided accounting advisory services. We have attached such article to this email for your reference.

Regarding the amendments under consideration in the ASU, we have the following comments to the Board's questions numbered below:

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.

Response: We agree with the Board's decision on scope to include all contractual restrictions that that prohibit the sale of an equity security. Furthermore, acknowledging the Board's reference "business combinations involving a special-purpose acquisition company" in paragraph BC8 of the proposed ASU, as well as our experience with the diversity in practice of measuring the fair value for equity securities issued as equity consideration in a SPAC merger transaction in accordance with Topic 805, we strongly recommend that the Board expand the scope of the proposed ASU to include the types of restrictions that typically accompany equity securities issued in SPAC merger transaction.

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?

Response: We agree that, for noninvestment companies (see our response to Question 3 below), 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. We generally believe that a Level 1 observable input of fair value is more desirable than a Level 3 input (i.e., a discount applied to an observable market price), thus, the fair value of an equity security subject to a contractual restriction should be measured on the basis of the market price of the same security without the contractual sale restriction. However, we believe equity securities issued with contractual restrictions by the seller as equity consideration in a merger transaction involving a special-purpose acquisition company (SPAC) should be provided an exception to the amendments in the proposed ASU due to the fact that the fair value of the "same security without the contractual restriction" criterion as of the merger date under Topic 805 would relate to a share price of the publicly-traded SPAC (which is simultaneously deregistered with the SEC) , and not to a share of the post-combination registrant (acquiree). Thus, we believe, in this particular fact pattern, the equity securities issued with contractual restrictions by the seller as equity consideration would incorporate such restrictions in the measurement of 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.

Response: No – We do not believe all types of entities should use the same unit of account when measuring the fair value of an equity security subject to a contractual sale restriction. We believe certain types of entities, such as investment companies, should be allowed to continue to incorporate the effects of a contractual restriction in the measurement of fair value. The Alternative Views in paragraphs BC18 through BC 28 of the proposed ASU have merit and deserve consideration. For example, for investment companies, the Board originally established specialized accounting under Topic 946 of the Codification to address the unique nature of an investment company's busines, the foundation of which is the computation of net asset value (NAV) applying the principles of fair value under Topic 820. We believe it would be incongruent to amend Topic 946 such that the core aspect of an investment company's accounting would be the same as a noninvestment company – to do so would negate the overall premise of the specialized industry that an investment company operates in. Furthermore, we agree with the Alternative Views in BC23 of the proposed ASU. While we acknowledge that the Board is normally the authoritative body that establishes generally accepted accounting principles (GAAP) where there is diversity in practice, we would recommend that the Board incorporate the guidance in Securities and Exchange Commission (SEC) ASR No. 113, *Restricted Securities* in the proposed ASU.

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 the information?

Response: Yes. We believe both qualitative and quantitative disclosures would help users in understanding the effects of a contractual restriction on the sale of an equity security held by a reporting entity. Such disclosures might include the nature of the contractual restriction, the related amount recognized in the balance sheet, how that amount was determined (e.g., Level 3 inputs and valuation technique used to derive the fair value of the contractual restriction) and the subsequent accounting for the contractual restriction. For example, would the fair value of the contractual restriction be remeasured at each reporting period during the contractually restricted period and, if so, what would be the financial statement impact of the change in fair value?

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

Response: For all entities except investment companies defined under Topic 946, we agree that the amendments in the proposed ASU should be applied prospectively. However, we disagree that any adjustments from the adoption of the proposed amendments be recognized in earnings on the date of adoption because we do not believe such adjustments should be treated as normal, recurring fair value measurement adjustments to equity securities held as investments. Rather, we believe the one-time adjustments from the adoption of the proposed amendment (which, in most cases, will result in an increase to the fair value of the equity security and resulting increase to current period earnings) be recorded as a component of other comprehensive income (OCI) until realized or, as an alternative, recorded as an adjustment to beginning retained earnings as of the adoption date.

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.

Response: We believe a sufficient amount of time would be necessary to implement the proposed amendments and that more time would be required by other than public entities than public entities. In substance, what the Board is requiring upon adoption of the proposed amendments is for an entity to "unwind" the discount for a contractual restriction of sale that has been previously incorporated into the measurement of fair value for the equity security. Regardless of what approach is agreed upon, this process is subjective, judgmental and may require the services of an independent valuation specialist

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?

Response: We believe the Board needs to provide more clarity to resolve existing diversity in practice. One is reminded of song "Putting a Band Aid Over a Bullet Hole." We believe the accounting implications for the issues discussed under the amendments are not as clear in practice as the proposed ASU purports them to be, and that the Board's introduction of the newly defined term "restricted security" as the underlying basis for the proposed amendments, while useful, needs to be expanded upon to address all types of equity offerings where there is a contractual restriction on sale/resale. If additional clarity and guidance is provided, we believe the proposed amendments would be operable and auditable.

Very truly yours,

J. Russell Frawley III, MBA, CPA/ABV

Principal

Frawley & Co. PLLC

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BUSINESS VALUATION UPDATE
TIMELY NEWS, ANALYSIS, AND RESOURCES FOR DEFENSIBLE VALUATIONS

Valuers Stand Ground in Clash Over Purchase Price in SPAC Merger

By J. Russell Frawley III, MBA, CPA, ABV, Frawley & Co. PLLC (Miami, Florida, USA)

A growing trend in the IPO arena is the use of a special purpose acquisition company (SPAC), which is a shell company that raises capital in an IPO and then acquires an operating company to form a new "merged entity." A key issue for valuation experts is determining the fair value of equity consideration issued in the SPAC merger transaction. A recent SPAC merger triggered a strong disagreement between a national valuation firm and the merged entity over this very issue. (*Note: This article does not disclose the identities of the parties involved (other than myself), and the financial data have been changed.*)

Background. The fair value of equity consideration issued in a merger in which a public company is the acquirer is generally calculated as the product of the quoted price for the individual equity instrument times the quantity issued (commonly referred to as "P times Q"). However, if the acquirer is a SPAC, determining "P" can be complex and could result in different interpretations of U.S. GAAP between the parties involved in the deal.

A SPAC raises capital in an IPO, typically at a $10.00 per share, and then acquires a target operating company within a specified period of time, normally 18 to 24 months from the date of the SPAC's IPO. In a SPAC merger, the SPAC acquires and merges with the target company, upon which the SPAC is dissolved and the surviving merged entity becomes the new public entity whose shares trade in the market on a go-forward basis, similar to the completion of an IPO. Sellers of the target company receive as purchase price consideration cash, rollover equity in the merged entity, or a combination of both, and the SPAC public stockholders receive rollover equity. SPAC mergers have become more common in the past few years (e.g. SPAC Diamond Eagle Acquisition Corp.'s merger with DraftKings, a popular sports betting online platform, in April 2020) as private companies seek to go public without the lengthy and costly regulatory process of a traditional IPO.

Illustrative example. In a recent SPAC merger transaction in which I was involved with, the merged entity issued the following types of equity consideration as components of the purchase price to the sellers:

Security Type	*Restriction*
Merged entity common share	180-day lock-up period
Merged entity deferred share	Vesting subject to occurrence of contingent event

The valuation question is: What is the fair value of the equity consideration issued in this SPAC merger transaction?

Acquirer's determination of fair value. The acquirer engaged a national valuation firm, with previous experience in SPAC merger transactions, to calculate the fair value of the common and deferred shares the merged entity issued on the merger date. Summarized below are the valuation specialist's calculations of fair value per share:

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Common Share	
Common share implied value	$10.00
Discount for lack of marketability	10%
Fair value per common share	$9.00

Deferred Share	
Common share implied value	$10.00
Discount for lack of marketability	30%
Fair value per deferred share	$7.00

In the valuation specialist's calculations above, the common share implied value represents the price per common share, as a component of the negotiated transaction price between the SPAC and sellers of the target company in accordance with the terms of the executed merger agreement. Based on the valuation specialist's interpretation of *ASC 805, Business Combinations*, the implied value was indicative of the price of the merged entity's common shares prior to and upon the consummation of the merger.

The discount for lack of marketability applied reflects the restrictions on transferability associated with the lock-up period and contingent event vesting conditions, respectively. In their opinion, the valuation specialist believed a market participant would take these restrictions into consideration in pricing the merged entity's common and deferred shares subsequent to the merger date, applying *ASC 820* interpretive guidance that states:

> A restriction that would transfer with the asset in an assumed sale would generally be deemed a characteristic of the asset and therefore would likely be considered by market participants in pricing the asset, and "a fair value measurement is for a particular asset or liability. Therefore, in 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, restrictions, if any, on the sale or use of the asset."

Merged entity disagrees. The merged entity, along with its independent auditors, did not concur with the valuation specialist's use of the implied value or application of a discount for lack of marketability in the determination of fair value of the merged entity's common and deferred shares. This presented a challenge for the merged entity as its independent auditors were required to review and sign off on the U.S. GAAP accounting treatment for the SPAC merger transaction in conjunction with the inclusion of the merged entity's financial statements in its initial SEC form 10-Q filing.

The merged entity regarded the implied value of $10.00 per common share as a transaction price, not an indication of fair value on the acquisition date. Rather, in its opinion, upon the consummation of the merger and the simultaneous exchange of SPAC common stock for merged entity common shares, the fair value of a merged entity common share was the quoted market price of the SPAC common stock of $12.00 on the date of the merger, in accordance with *ASC 820*, which states:

> [A] quoted price in an active market provides the most reliable evidence of fair value and shall be used without adjustment to measure fair value whenever possible. The merged entity also relied on interpretive guidance of ASC 805, which stated, "if the acquirer issues equity instruments to the acquiree in the business combination, then the acquirer measures the fair value of the equity instruments on the acquisition date and includes that amount as part of the consideration transferred."

As a result, the total fair value of equity consideration issued to the sellers would be calculated using "P times Q," as discussed above.

In addition, the merged entity considered the restrictions on transferability to be post-vesting restrictions, analogizing to the guidance in *ASC 718, Share-Based Compensation*, which states:

> Certain post-vesting restrictions, such as a contractual prohibition on selling shares for a specified period of time after vesting, are essentially the same restrictions that may be present in equity instruments exchanged in the marketplace.

Finally, the merged entity referred to interpretive SEC guidance its independent auditors provided on the topic of discounts for lack of transferability applied to a security, in which stated that "absent cash transactions in the same or similar instruments, an appraisal of the fair value of the shares by an independent expert generally provides the best evidence of fair value. However, the SEC staff typically examines carefully the determination of the fair value of equity securities. In particular, the SEC staff has aggressively challenged significant discounts from the market price of freely transferable equity securities when valuing equity securities with restrictions. In the absence of objective and verifiable evidence that supports the fair value of the restricted securities, the SEC staff generally presumes that the best available evidence of fair value is the quoted market price of traded securities with similar, but not identical characteristics (generally, the similar traded, unrestricted security)."

Agree to disagree. The valuation firm maintained its position as to its conclusion of value and did not change its valuation report. The merged entity's management was ultimately required to provide assertions in the final report as to the use of $12.00 per share for the fair value of the merged entity's common and deferred shares issued as equity consideration on the merger date.

As this case illustrates, the determination of fair value of equity consideration issued as components of the purchase price in a SPAC merger transaction could be subject to disagreements in the interpretation of U.S. GAAP business combination and fair value guidance between the parties to the deal, which must be resolved prior to the issuance of the merged entity's financial statements.

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