



# How FASB's Proposed Amendment to ASC Topic 820 will Impact Alternative Asset Investors

James L. Kroeker, Vice Chair, Financial Accounting Standards Board  
David L. Larsen, Kroll Institute Fellow and Managing Director, Kroll

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# James L. Kroeker

## Vice Chairman, Financial Accounting Standards Board



James L. Kroeker was appointed a member and vice chairman of the Financial Accounting Standards Board (FASB) on September 1, 2013, later reappointed to a second term that extends to June 30, 2024. In the latter role, he assists the FASB chairman in representing the Board to external stakeholders and in conducting its internal operations, in addition to serving as a voting member of the Board.

Prior to joining the FASB, Mr. Kroeker served as the Deputy Managing Partner for Professional Practice for Deloitte. Before joining Deloitte in January 2013, he was the Chief Accountant of the Securities and Exchange Commission (SEC) from January 2009 until his departure in 2012. In that capacity, Jim served as the senior accounting professional for the Commission and the principal advisor to the Commission on all accounting and auditing matters. In his capacity at the SEC, he was responsible for resolution of a wide range of globally significant accounting and auditing issues.

While at the Commission (he joined in February 2007), Jim played a key role in efforts to improve the transparency and reduce the complexity of financial disclosure. He served as staff director of the SEC's Congressionally-mandated study of fair value accounting standards, and he led the efforts of the Office of the Chief Accountant to address the economic crisis, including steps to improve off-balance sheet accounting guidelines. Jim also served as the Designated Federal Officer responsible for the staff oversight of the SEC's Advisory Committee on Improvements to Financial Reporting. He also was responsible for the day-to-day operations of the office, including resolution of accounting and auditing practice issues, rulemaking, and oversight of the FASB and PCAOB.

Prior to joining the SEC, Jim was a partner at Deloitte in the firm's Professional Practice Network and was responsible for providing consultation and support regarding the implementation, application, communication and development of accounting standards, including disclosure and reporting matters. Jim was Deloitte & Touche's representative on the AICPA Accounting Standards Executive Committee (AcSEC). He also served as a Practice Fellow at the Financial Accounting Standards Board.

Jim received a Bachelor of Science degree with an emphasis in accounting from the University of Nebraska in May 1992.

# David L. Larsen, CPA/ABV/CEIV

## Managing Director, Alternative Asset Advisory



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David Larsen is a managing director in the Seattle office of Duff & Phelps and part of the Alternative Asset Advisory service line. He has more than 35 years of transaction and accounting experience. He specializes in fair value accounting issues, and specifically in valuation, accounting, and regulatory issues faced by Alternative Asset managers and investors.

David advises leading Private Equity Managers and Institutional Investors and has advised numerous strategic and private equity acquirers in all areas of mergers, acquisitions, joint ventures, divestitures and valuation related matters. He provides valuation policy and process assistance to a number of the world's largest institutional limited partner investors and some of the world's largest alternative Investment managers. David is a member of the International Valuation Standards Council Standards Review Board, an advisor to and has served as Vice Chair of the International Private Equity and Venture Capital Valuations Board (IPEV), which in 2018 released updated International Private Equity Valuation Guidelines and serves as a member of the American Institute of Certified Public Accountants (AICPA) PE/VC Practice Guide Task Force. David has served as a special advisor to the Institutional Limited Partners Association; board member, project manager and technical advisor to the Private Equity Industry Guidelines Group and was instrumental in developing and drafting the Private Equity Industry Guidelines Group's Valuation and Reporting Guidelines; member of the Financial Accounting Standards Board's Valuation Resource Group responsible for providing the Board with input on potential clarifying guidance on issues relating to the application of the principles of FASB ASC Topic 820 (formerly SFAS No. 157), *Fair Value Measurements* and a member of the AICPA Net Asset Value Task Force.

Prior to joining Duff & Phelps, David was a Partner in KPMG LLP's Transaction Services practice, where he was the segment leader of KPMG's U.S. Institutional Investor practice. He served 13 years in KPMG's Seattle, Düsseldorf and Prague audit practices prior to moving full time to advisory work.

David received his M.S. in accounting from Brigham Young University's Marriott School, his B.S. in accounting from Brigham Young University. He is a certified public accountant licensed in California and Washington. David is also a member of the AICPA and the California and Washington Society of Certified Public Accountants and is a FINRA Series 7, 24 and 63 registered representative.

# About Kroll

# About Kroll

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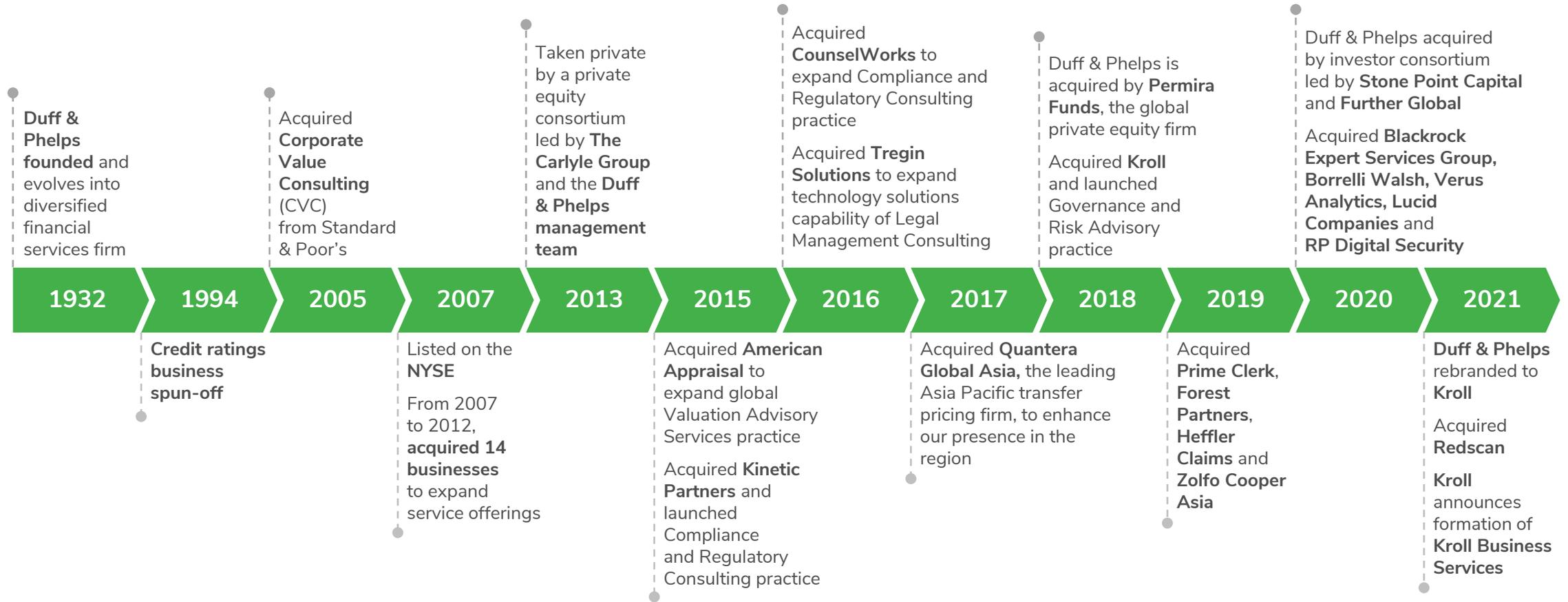
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#1 Total Number of U.S. and Global Fairness Opinions Over the Past 10 Years<sup>1</sup>

#5 U.S. Middle-Market Transactions Over The Past 10 Years<sup>2</sup>

Leading patent consulting firm<sup>11</sup>

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**Best** Cyber Security Services Provider<sup>4</sup>

**Best** Compliance Consultancy Firm<sup>5</sup>

**Thought Leader** in Digital Forensics, Arbitration and Investigations<sup>3</sup>

International Mid-Market M&A Advisory Firm of the Year in Canada – 2020<sup>6</sup>

**Thought Leader** in Corporate Tax and Digital Forensics<sup>7</sup>

**Best Valuations Firm** for Hard-to-Value Assets<sup>8</sup>

**Kroll recognized** as Pacesetter in the ALM Intelligence: Cybersecurity Services 2020

Duff & Phelps and Kroll named **Best Compliance Consultant/Advisor**<sup>10</sup>

Recommended Vendor for Security Incident Response in Gartner® Invest Analyst Insight: SRM 2020 and 2019

1. Source: Thomson Reuters' cumulative data 2011-2020
2. Source: Thomson Financial Securities Data (U.S. deals \$10M < \$150M, including deals without a disclosed value). Full years 2011 through 2020
3. Who's Who Legal 2018-2020: Forensic and Litigation Consulting.
4. HedgeWeek 2018

5. HFM European Quant Awards 2019
6. 2020 Corporate INTL Global Awards
7. Who's Who Legal 2019
8. 11th Annual HFM European Hedge Fund Services Awards in 2019

9. America's Best Management Consulting Firms – Forbes
10. Compliance Week's 2020 Excellence in Compliance Awards
11. I AM Patent 1000 2020

# Valuation professional affiliations

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# Overview of proposed changes

# Summary of Proposed Accounting Standards Update

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



### Why Change?

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To clarify guidance in Topic 820 on measuring the fair value of an equity security that addresses contractual restrictions that prohibit the sale of an equity security.



### Who is impacted?

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All entities (not just investment companies) that have investments in equity securities measured at fair value that are subject to contractual restrictions preventing sale.



### Impact of Changes?

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The proposed amendments are intended to clarify current GAAP, reduce diversity in practice, reduce cost and complexity, and increase comparability. However, for investment companies, reported NAV may increase and may not reflect the amount that would be received in an orderly transaction for a fund interest.

## Existing Standard (ASC Topic 820)

Fair value is defined as **the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.**

**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.

# Proposed Change to Master Glossary

## Restricted Security

An equity security **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.**

# Proposed Change to Paragraph 820-10-35-6B

**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 equity security 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).**

## Proposed Change to Paragraph 820-10-35-36B

**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.

# Proposed Change to Paragraph 820-10-55-52

**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 equity security 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.

# **Impact on Investment Company Financial Statements and Net Asset Value (NAV) reported to Investors (LPs)**

# Impact of the proposed amendment

## Some Examples

- IPO with 6-month underwriters lockup (1,000,000 shares; IPO price \$ 50 – fair value = \$50,000,000)
  - Current GAAP – NAV reported to LPs \$45,000,000 (assuming 10% discount reflecting the 6-month lockup)
  - Proposed GAAP – NAV reported to LPs \$ 50,000,000

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- Fund A Invests \$500,000,000 and Fund B Invests \$ 150,000,000 into a SPV; the SPV purchases \$ 650,000,000 of a publicly traded equity security.
  - Contractually, Fund A cannot exit for 4 years other than at Fund B's discretion
  - Contractually, Fund A receives the first \$ 650,000,000 of returns; Fund B receives the next \$300,000,000 million; pari-passu thereafter.
- What is the fair value of Fund A's interest on Day 1
  - Existing GAAP, \$ 500,000,000 (calibration implies that the \$ 150,000,000 or 23% discount to the SPV value of \$ 650,000,000 is the market participant impact of a 4-year contractual restriction).
  - Proposed GAAP, \$ 650,000,000 (contractual restriction must be ignored)
- Will LPs care that NAV (which is the basis for the LPs fair value measurement) is \$650,000,000 rather than \$500,000,000?
- Or could it be argued that the Unit of Account is the interest in the SPV and therefore the impact of the contractual restriction can be reflected in the fair value estimate?

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- SPAC Founder Shares (Class B) – pre deSPACing not registered. Underwriters lockup 6 months after deSPACing. SPAC A shares trading at \$ 10.50.
- Probability of deSPACing 70% at the measurement date.
- How should the Founder Shares be valued?
  - Current GAAP (probability of success X discount for time to contractual restriction expiration X value of an A share without a trust floor = ?? \$ 4 ??)
  - Proposed GAAP ?? \$ 10.50 ??

# Effective Date and Transition

## For Investment Companies

- Effective for all entities for fiscal years beginning after December 15, 202X
- 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.

# Input Requested

## FASB Questions

- FASB requests comments by November 14, 2021:
- Specific Questions:
  - **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?

# Questions?