IASB/FASB Joint Meeting – 17-18 November 2010

IASB Agenda reference **2C**

Staff Paper

FASB ED Session – November 10, 2010

FASB Agenda reference **20**

Project	**Fair value measurement**
Topic	**Premiums and discounts in a fair value measurement**

Purpose of this paper

1. This paper discusses the application of premiums and discounts in a fair value measurement.

2. This paper asks the boards to:

   (a) determine whether the application of a blockage factor is consistent with the objective of a fair value measurement at any level of the fair value hierarchy; and

   (b) distinguish blockage factors from other possible premium and discount adjustments (eg control premiums and discounts related to liquidity) and emphasise that other premium and discount adjustments may be consistent with the objective of a fair value measurement depending on the unit of account specified in other standards.

3. This paper does <u>not</u> address the applicability or appropriateness of applying premiums and discounts in Level 1 of the fair value hierarchy.

4. The appendix to this paper contains the FASB's rationale for its decisions on blockage factors when developing FASB Statement of Financial Accounting

Standards No. 157, *Fair Value Measurements* (Statement 157),[1] and the exposure draft of a proposed Accounting Standards Update (ASU), *Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*.[2]

5. Please note that the premiums and discounts discussed in this paper do not represent all possible premium and discount adjustments that may be applied in a fair value measurement. The boards have concluded that it would not be helpful to try to describe all circumstances that might give rise to a premium or discount when measuring fair value, nor to define all of the potential premium and discount adjustments that could be applied in a valuation. Such information is best provided by the valuation community.

6. This issue does not pertain to non-financial assets because the proposed guidance for non-financial assets acknowledges that the unit of valuation can differ from the unit of account when the highest and best use of an asset provides maximum value to market participants through its use in combination with other assets as a group.

Summary of the proposals[3]

7. The FASB's exposure draft of a proposed ASU does not define a block. Instead, it refers to 'a position in a single asset or liability (including a position comprising a large number of identical assets or liabilities, such as a holding of financial instruments)' (see paragraph 820-10-35-36C).

8. The exposure draft describes a blockage factor as an adjustment to the quoted price for the asset or liability because of the size of the position relative to

[1] Topic 820, *Fair Value Measurements and Disclosures*, in the FASB's Accounting Standards Codification™ codified Statement 157.
[2] The rationale in the FASB's basis for conclusions is consistent with the rationale in the IASB's comprehensive project summary posted to the IASB website in June 2010.
[3] The proposal is identical to the IASB staff draft of a forthcoming IFRS on fair value measurement posted on the IASB website in August 2010.

trading volume when a market's normal daily trading volume is not sufficient to absorb the quantity held and placing orders to sell the asset or liability in a single transaction might affect the quoted price. The exposure draft states that when an entity uses a quoted price for the asset or liability (or similar assets or liabilities) as an input into a fair value measurement, the entity may not adjust that quoted price for a blockage factor.

9. The exposure draft prohibits the use of blockage factors in **Level 1** of the fair value hierarchy. The exposure draft also prohibits the use of blockage factors in **Level 2** of the fair value hierarchy to the extent that the Level 2 fair value measurement is determined based on the quoted price for an identical or similar asset or liability (eg when using a market approach to value a financial instrument using quoted prices for comparable securities). The boards concluded that the application of a blockage factor to a quoted price is not appropriate in a fair value measurement because:

   (a) an entity's decision to incur a blockage factor is specific to the entity, not to the asset or liability (mainly because of the unit of account); and

   (b) an entity only incurs a blockage factor when it enters into a transaction to sell the block. As a result, blockage factors are a characteristic of the transaction to sell, not of the asset or liability (and in this way are like transaction costs).

10. The exposure draft states that a blockage factor is not relevant when fair value is measured using a valuation technique that does not use a quoted price for the asset or liability (or similar assets or liabilities). For example, a blockage factor would not be relevant for a **Level 3** fair value measurement that is estimated using a discounted cash flow approach because there would be no basis for making an 'adjustment to a price' as there is *no observable market price to affect*. Similarly, a blockage factor would not be relevant for a **Level 2** fair value measurement that is estimated using observable inputs other than quoted prices.

11. The boards proposed this guidance because the term blockage factor has been used very broadly in practice and the boards meant to distinguish between

blockage factors and other possible premium and discount adjustments and to clarify, in principle, when it is appropriate to apply premium and discount adjustments in a fair value measurement.

12. The exposure draft does not preclude the use of other premium and discount adjustments if such adjustments would be made by market participants when pricing the assets or liabilities, given the unit of account specified in other standards. For example, an entity would apply a control premium adjustment when measuring the fair value of a controlling interest if market participants also would do so (and the unit of account is the controlling interest).

Overview of comments received

13. The Questions for Respondents accompanying the FASB's exposure draft asked interested parties the following:

    (a) whether they think the proposed clarification of the meaning of a blockage factor is appropriate;

    (b) whether they think the decision to prohibit the use of a blockage factor when fair value is measured using a quoted price for an asset or a liability (or similar assets or liabilities) is appropriate;

    (c) whether the proposal to specify that other premium and discount adjustments (eg a control premium or a non-controlling interest discount) should be taken into account in fair value measurements categorised within Levels 2 or 3 of the fair value hierarchy when market participants would take into account those premiums and discounts when pricing an asset or a liability consistent with its unit of account for that asset or liability; and

    (d) how they might apply the proposed guidance in practice when the unit of account for a particular asset or liability is not clearly specified in another standard.

14. Respondents generally support the additional guidance on the meaning of a blockage factor and distinguishing it from other possible premium and discount adjustments in a fair value measurement. Some note that the term 'blockage' has been used very broadly in practice to pertain to any discount or premium related to size or liquidity.

15. Some respondents disagree with the prohibition of blockage factors in any level of the fair value hierarchy. They note that if a large holding of a financial instrument were sold, it could not be disposed of at a value that equals the quoted price multiplied by quantity held when that quoted price is based on a significantly smaller lot size. Having said that, many of those respondents understand the boards' rationale for prohibiting the application of blockage factors in Level 1.

16. Many respondents ask the boards to clarify the following:

    (a) why an entity can apply a control premium but not a blockage factor when the application of both depend on the size of a holding;

    (b) distinguishing between blockage factors and adjustments for liquidity and concentration risk; and

    (c) whether it is appropriate to recognise a gain or loss at initial recognition when a premium or discount (eg a blockage factor) was priced into the transaction to buy an instrument but cannot be applied in the fair value measurement for accounting purposes and to recognise a loss or gain upon an actual exit transaction.

Staff analysis and recommendation

17. This section:

    (a) analyses the meaning of a block;

    (b) analyses whether a blockage factor is consistent with the objective of a fair value measurement;

(c) analyses concerns about gains or losses at initial recognition; and

(d) sets out the staff's recommendations.

What is a block?

18. As noted above, the exposure draft refers to a block as 'a position in a single asset or liability (including a position comprising a large number of identical assets or liabilities, such as a holding of financial instruments)'. Some respondents noted that such a description refers to any large position, including a controlling interest. Much of the confusion over blockage factors seems to stem from a lack of clarity about when the unit of account is an individual asset or liability or when it is a 'holding' (whether large or small).

19. As a result, there is a concern that the boards' decision to specify that blockage factors are prohibited when a fair value measurement is determined on the basis of a quoted price and are not relevant otherwise meant that the size of an entity's holding should *never* be taken into account in a fair value measurement. This was not the boards' intention.

20. Tension arises because the unit of account for a financial instrument is an individual instrument and entities typically do not transact at the individual instrument level. Instead, entities typically buy and sell *groups* of financial instruments. Because of this, it is difficult for many to conceptualise a measurement for an individual instrument.

21. This is further complicated when an entity holds a controlling interest in another entity (eg an investment company measuring the fair value of its investment in an investee in US GAAP or a parent company measuring the fair value of its investment in a subsidiary in IFRSs) when that interest takes the form of debt and equity instruments and when the fair value of debt and equity instruments is meant to be measured on an individual instrument basis. In such situations, the staff thinks the boards did not necessarily intend for the unit of account to be each individual instrument, but the controlling interest investment and noted that

this question was outside the scope of this project (see Agenda Paper 2E (IASB) / 16 (FASB) for the October 2010 joint meeting).

22. The staff thinks the description of a block ('a position in a single asset or liability [including a position comprising a large number of identical assets or liabilities, such as a holding of financial instruments]') does not distinguish between the unit of account and the size of an entity's holding, which might differ. That description seems to assume that market participants would sell their entire holding, yet prohibits an entity from measuring fair value in that way—and implies that this is the case whether the entity has a controlling or non-controlling interest.

23. The staff thinks it would be helpful to address premium and discount adjustments by providing guidance in the context of the unit of account for the asset or liability (which would be as determined in the standard prescribing the item to be measured at fair value) rather than describing what a 'block' is, given that the description of a 'block' might differ from the unit of account prescribed in other standards, and the wording in the exposure draft seems to have caused some confusion about what is being measured and on what basis (controlling, non-controlling, etc.).

Is the use of a blockage factor consistent with the objective of a fair value measurement?

24. The objective of a fair value measurement is to estimate the price at which an orderly transaction to sell an asset or transfer a liability would take place between market participants at the measurement date under current market conditions. As such, fair value is a market-based measurement, not an entity-specific measurement, and a particular entity's intentions for an asset or a liability are not relevant to the extent that those intentions differ from the intentions of market participants in the same situation.

25. With respect to premiums and discounts, a fair value measurement for financial reporting purposes relies on:

(a) the unit of account for the asset or liability; and

(b) the characteristics of the asset or liability.

26. Both of these would determine how market participants would (or would not) price the asset or liability, and neither of them are determined on the basis of a transaction or possible transaction. In other words, the characteristics of an asset or liability exist whether the asset or liability is held or sold.

27. Having said that, it is difficult for many to conceptualise a measurement that uses a unit of account (which for a financial instrument is an individual instrument) that differs from the level at which entities typically transact (which is usually a *group* of financial instruments).

28. In fact, outside of a financial reporting framework, premiums and discounts often are applied on the basis of the size of the entity's holding because there is an assumption that market participants would transact on that basis. Outside of financial reporting, entities do not need to consider a particular unit of account. As a result, they apply premiums and discounts (including blockage factors) for a number of different reasons to account for a variety of perceived benefits or risks associated with the assets or liabilities being sold.

29. The boards are concerned with fair value measurement for financial reporting purposes and have to give consideration to how fair value should be measured for that particular purpose.

30. The boards have concluded that a blockage factor depends on an entity's decision to enter into a transaction to sell an asset or liability at a level other than its unit of account, which is an entity-specific decision and is a characteristic of the transaction, not of the asset or liability.

31. The staff thinks that, unless the boards decide to change the unit of account for financial instruments, a blockage factor is inconsistent with the objective of a fair value measurement.

Gains or losses at initial recognition

32. As noted above, some respondents are concerned about recognising a gain or loss at initial recognition for fair value measurements categorised within Levels 2 or 3 of the fair value hierarchy when a transaction price includes a particular premium or discount but a fair value measurement does not. In addition, they are concerned that it is misleading to recognise a loss or gain upon an actual exit transaction.

33. For example, if a broker-dealer purchases a large lot of shares in a private placement of equity securities at a discount from the price in the principal market, the broker-dealer would recognise a gain in the amount of the difference between the fair value and the transaction price.[4]

34. The staff thinks this is a consequence of a decision to allow the recognition of gains and losses when a transaction price differs from fair value at initial recognition, not an issue about the appropriateness of a blockage factor.

35. In the example above, the gain is a result of a difference between:

    (a) the market in which the securities were purchased (the transaction) versus the principal market for the securities (the fair value); and

    (b) the unit of account for the transaction and the unit of account for the fair value measurement.

36. The staff thinks the guidance on gains or losses at initial recognition is sufficient for addressing this situation. The boards have consistently said that the objective of a fair value measurement is to provide a market benchmark to use as a basis for assessing an entity's advantages or disadvantages in performance or settlement relative to the market. Therefore, when an asset or liability is measured at fair value, the relative efficiency or inefficiency in exiting the

[4] This would be the case for assets and liabilities categorised within Level 1 of the fair value hierarchy. However, this paper does not address the appropriateness of blockage factors in Level 1.

position appears in earnings/profit or loss at the time of an actual transaction, and not before.

Staff recommendation

37. The staff recommends the following:

    (a) not to allow consideration of discounts and premiums in a fair value measurement when such discounts or premiums are inconsistent with the unit of account specified in other standards (this is consistent with the proposal in the exposure draft). By doing this, any changes to the unit of account in other standards after the finalisation of the fair value measurement standard would not require further amendments to the fair value measurement standard;

    (b) not to explicitly describe or distinguish between any premiums or discounts that might be applied in a fair value measurement. Because the relevance and amount of premiums and discounts depends on the particular facts and circumstances of the valuation, it seems inappropriate to specify which premiums or discounts might be applied in which circumstances;

    (c) not to address the recognition of gains or losses when a transaction price differs from fair value because of the existence of a blockage factor.

Question 1
Do the boards agree with the staff recommendation in paragraph 37? If not, what do you propose and why?

Appendix

Basis for conclusions in Statement 157

C76. In developing this Statement, the Board decided to address that inconsistency within GAAP. The Board considered the earlier work completed by AcSEC through its Blockage Factor Task Force, which was formed in 2000 to address issues specific to the use of blockage factors (discounts) by broker-dealers and investment companies. Based on its discussions with industry representatives (broker-dealers, mutual funds, and other investment companies) and a review of relevant academic research and market data, the task force affirmed that discounts involving large blocks exist, generally increasing as the size of the block to be traded (expressed as a percentage of the daily trading volume) increases but that the methods for measuring the blockage factors (discounts) vary among entities and are largely subjective.

C77. In the Exposure Draft, the Board acknowledged the diversity in practice with respect to the methods for measuring blockage factors (discounts). However, the Board agreed that for entities that regularly buy and sell securities in blocks, the financial reporting that would result when using P×Q to measure the fair value of a block position would not be representationally faithful of the underlying business activities. In particular, if a block is purchased at a discount to the quoted price, a fair value measurement using P×Q would give the appearance of a gain upon buying the block, followed by a reported loss on subsequently selling the block (at a discount to the quoted price). At that time, the Board understood that for blocks held by broker-dealers, industry practice was to also sell the securities in blocks. In view of that selling practice (in blocks), the Board decided that this Statement should allow the exception to P×Q in the Guides to continue, thereby permitting the use of blockage factors by broker-dealers and certain investment companies that buy or sell securities in blocks.

C78. Many respondents, in particular, broker-dealers, agreed with that decision. However, during its redeliberations, the Board discussed the need for expanded disclosures about blocks measured using blockage factors with representative preparers (broker-dealers) and users (analysts that follow broker-dealers). Through those discussions, the Board learned that for blocks held by broker-dealers, industry practice is often to sell the securities in multiple transactions involving quantities that might be large but that are not necessarily blocks; that is, the securities could be sold at the quoted price for an individual trading unit. Because of that selling practice, the majority of the Board decided that there was no compelling reason to allow the exception to P×Q in the Guides to continue under this Statement, noting that revised IAS 39 includes similar guidance in paragraph AG72, which states that “the fair value of a portfolio of financial instruments is the product of the number of units of the instrument and its quoted market price.”

C79. In reaching that decision, the majority of the Board affirmed its conclusions relating to the prohibition on the use of blockage factors in other FASB Statements. In particular, the Board emphasized that when a quoted price in an active market for a security is available, that price should be used to measure fair value without regard to an entity's intent to transact at that price. Basing the fair value on the quoted price results in comparable reporting. Adjusting the price for the size of the position introduces management intent (to trade in blocks) into the measurement, reducing comparability. Following the reasoning used in Statement 107, the quoted price provides useful information because investors regularly rely on quoted prices for decision making. Also, the decision to exchange a large position in a single transaction at a price lower than the price that would be available if the position were to be exchanged in multiple transactions (in smaller quantities) is a decision whose consequences should be reported when that decision is executed. Until that transaction occurs, the entity that holds the block has the ability to effect the transaction either in the block market or in another market (the principal or more advantageous market for the individual trading unit).

C80. This Statement precludes the use of blockage factors and eliminates the exception to P×Q in the Guides for a financial instrument that trades in an active market (within Level 1). In other words, the unit of account for an instrument that trades in an active market is the individual trading unit. This Statement amends Statements 107, 115, 124, 133, and 140 to remove the similar unit-of-account guidance in those accounting pronouncements, which referred to a fair value measurement using P×Q for an instrument that trades in any market, including a market that is not active, for example, a thin market (within Level 2). In this Statement, the Board decided not to specify the unit of account for an instrument that trades in a market that is not active. The Board plans to address unit-of-account issues broadly in its conceptual framework project.

Basis for conclusions in Exposure Draft

BC33. Topic 820 generally prohibits any adjustment to a quoted price in an active market for an identical asset or liability (including a blockage factor or other premiums or discounts) for a fair value measurement categorized within Level 1 of the fair value hierarchy. However, Topic 820 does not specify whether a blockage factor (or another premium or discount, such as a control premium or a noncontrolling interest discount), can be applied in a fair value measurement categorized within Level 2 or Level 3 of the fair value hierarchy.

BC34. The IASB Exposure Draft on fair value measurement proposed an amendment to IAS 39 specifying that the unit of account for a financial instrument is the individual financial instrument at all levels of the fair value hierarchy. That proposal effectively would prohibit the application of blockage factors and other premiums and discounts in a fair value measurement categorized within any level of the fair value hierarchy for financial instruments within the scope of IAS 39.

BC35. The IASB proposed that guidance for the following reasons:

a. The unit of account for a financial instrument should not change because of the instrument's categorization within the fair value hierarchy.

b. Market participants will enter into a transaction to sell a financial instrument at the most advantageous price for the instrument. A reporting entity's decision to sell at a less advantageous price because it sells an entire holding rather than each instrument individually is a factor specific to that reporting entity.

BC36. That proposal was consistent with Topic 820 for fair value measurements categorized within Level 1 of the fair value hierarchy, but it was interpreted by respondents as being inconsistent with Topic 820 for fair value measurements categorized within Level 2 and Level 3 of the fair value hierarchy. Most respondents to the IASB Exposure Draft on fair value measurement did not support the IASB's proposal on blockage factors because, in their view, reporting entities do not typically exit a position on an individual instrument basis (for example, entering into a transaction to sell a single share of common stock). As a result, they believe the fair value measurement should reflect the fair value of the holding, not of each individual instrument comprising the holding (that is, they do not agree that the unit of account for a financial instrument should be the individual instrument). The FASB received similar comments when Statement 157 was issued.

BC37. The comments received on the IASB Exposure Draft also indicated that respondents have different interpretations about what the term blockage factor means. For example, some respondents thought the IASB intended to prohibit the application of a premium or discount (such as a control premium) even when market participants would take into account a premium or discount when pricing the asset or liability for that unit of account (for example, a controlled investment accounted for in accordance with IAS 27).

BC38. As a result of those comments, as well as the comments the FASB has received from its constituents about the implementation of Topic 820 on the application of blockage factors and other premiums or discounts in a fair value measurement, the Board concluded that it is necessary to clarify what a blockage factor is and to specify whether and, if so, when a blockage factor or another premium or discount should be taken into account in a fair value measurement.

BC39. The Board concluded that the current description of a blockage factor in U.S. GAAP accurately describes what a blockage factor is. Topic 820 states that a blockage factor is an adjustment to a quoted price for an asset or a liability when the normal daily trading volume for the asset or liability is not sufficient to absorb the quantity held and placing orders to sell the asset or liability in a single transaction might affect the quoted price. Blockage factors are most commonly observed in transactions for financial instruments, such as equity or debt securities. The description of a blockage factor in this proposed Update is unchanged from the description in Topic 820.

BC40. However, Topic 820 does not distinguish between a blockage factor, as described in the preceding paragraph, and other premiums and discounts, nor does it describe those other premiums or discounts (with the exception of an adjustment for liquidity risk, which is described in the guidance for measuring the fair value of an asset or a liability in an inactive market). Other Topics, such as the guidance in Topic 350, Intangibles—Goodwill and Other, and the guidance in Topic 805, Business

Combinations, refer to the application of control premiums and noncontrolling interest discounts.

BC41. The Board decided to use the principle underlying a fair value measurement (that is, a fair value measurement takes into account the characteristics of the asset or liability that market participants would take into account when pricing the asset or liability given the unit of account specified in another Topic) when describing the application of other premiums and discounts in a fair value measurement. Therefore, the amendments in this proposed Update specify that a reporting entity would apply a premium or discount in a fair value measurement if market participants would take into account such a premium or discount when pricing the asset or liability given the unit of account specified in another Topic (for example, a market participant is likely to consider a control premium when pricing a reporting unit). The Board decided not to provide detailed descriptions of other premiums and discounts or to provide detailed guidance about their application in a fair value measurement. The Board concluded that such descriptions and guidance would be too prescriptive and that the application of such premiums and discounts depends on the facts and circumstances.

BC42. Given the description of a blockage factor, the Board concluded that a reporting entity's decision to incur a blockage factor is specific to that reporting entity, not to the asset or liability. Furthermore, a blockage factor is observed when the quantity held is greater than the normal daily trading volume for the asset or liability. In many cases, the unit of account for a financial instrument is the individual financial instrument. In such cases, the size of a reporting entity's holding is not relevant. A reporting entity would only incur a blockage factor when that reporting entity decides to enter into a transaction to sell a block comprising a large number of identical assets or liabilities. In that way, blockage factors are like transaction costs and will differ depending on how a reporting entity enters into a transaction for an asset or a liability. The Board believes that if a reporting entity decides to enter into a transaction to sell a block, the consequences of that decision should be reported when the decision is carried out, which is consistent with the Board's rationale in developing Statement 157.

BC43. Because the decision to incur a blockage factor is specific to the reporting entity, the Board decided to prohibit its application, even when a reporting entity expects to incur a blockage factor upon the sale of an asset or a liability. The Board concluded that a blockage factor could arise only when fair value is measured using a quoted price for the asset or liability (or similar assets or liabilities). As a result, the Board concluded that a blockage factor would not be relevant when fair value is measured using a valuation technique that does not use a quoted price for the asset or liability (or similar assets or liabilities).

BC44. In addition, the Board decided to specify that fair value measurements categorized within Level 2 and Level 3 of the fair value hierarchy would take into account other premiums or discounts that market participants would take into account when pricing an asset or a liability given the unit of account specified in another Topic (for example, a noncontrolling interest discount). The Board concluded that a fair value measurement would take into account those premiums or discounts that represent a characteristic of the asset or liability that would transfer to a market participant.