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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**December 2008, London**
Project:	**Fair Value Measurement**
Subject:	**Control premiums (Agenda paper 3F)**

Introduction

1 At its September 2008 meeting, the Board discussed whether a fair value measurement should include an adjustment for the size of an entity's holding relative to trading volume (a blockage factor).

2 The Board confirmed its preliminary view, expressed in the discussion papers on *Fair Value Measurements* and *Reducing Complexity in Reporting Financial Instruments*, that the measurement objective should be to measure fair value at the individual instrument level.

3 At that meeting, the Board tentatively decided:

a to exclude blockage factors from a fair value measurement at all levels of the fair value hierarchy.

b that a fair value measurement should exclude other discounts or premiums (such as a control premium) that apply to a holding of financial instruments and do not apply to the individual instrument.

4 This paper asks the Board to reconsider its decision in (b) about control premiums and other discounts or premia that are not related to the liquidity of a holding and for which the unit of account might not be the individual instrument. This paper does <u>not</u> address holdings that are large enough to convey a fairly high level of significance (eg significant influence in IAS 28 *Investments in Associates*) but do not necessarily give control because IAS 28 does not address investments measured at fair value under IAS 39 *Financial Instruments: Recognition and Measurement*.

5 The Board's decision has implications for the fair value of consideration transferred (purchase price) in a business combination and the recoverable amount of a cash-generating unit (when the recoverable amount is measured on the basis of fair value less costs to sell) in an impairment test. It also affects the fair value of a parent company's investment in a subsidiary in the parent company's separate financial statements.

Staff analysis

What is a control premium?

6 A control premium is the additional price that any market participant buyer would have to pay (and the amount a market participant seller would expect to receive) for a controlling interest in another entity and typically exists whenever any size controlling stake is acquired, whether or not it is for 100 per cent of the acquiree.

7 Control gives the acquirer the ability to direct the use of the assets within the business. In the case of a strategic buyer, control allows the acquirer to (try to) realise the synergy potential to be gained from the combination of the two companies. In other words, the control premium is not a quantification of the expected synergies, but it is the price that must be paid **for the opportunity** to realise the synergies.

8 The size of the control premium is based on several factors, including the existence of non-operating assets or operational inefficiencies, the quality of management, and any

potential business opportunities that are not currently being exploited. However, the **observed** premium paid to acquire a controlling stake in an entity not only reflects the premium for control, but it also might include other factors. It is therefore difficult, if not impossible, to assess the 'true' premium paid for control.

How is a control premium different from a blockage factor?

9 A blockage factor is an estimate of the reduction in the quoted price of an instrument (usually an equity security) that would occur if a market participant were to sell a large holding of instruments at once. It represents a cost due to the lack of liquidity in the market for a large holding of instruments.

10 In the September meeting, the Board discussed whether blockage factors depend on entity intent (ie whether the entity intends to sell the instruments as a block or individually over time).

11 A control premium is not related to liquidity, nor is it about the entity's intent—it represents the value of having control over an entity, as opposed to being a passive investor in the same entity.

12 Measuring the fair value of a block of financial instruments at the share price times the quantity held (PxQ) promotes comparability across entities that hold the same instrument. For a controlling interest, this factor is not relevant because only one entity can hold the controlling interest.

13 Control premiums and blockage factors both relate to the size of a holding. That means it is worth considering the unit of account.

Unit of account in IFRS 3, IAS 27 and IAS 36

14 The Board made its decision about blockage factors because the unit of account of a financial instrument in IAS 39 is the individual instrument (keeping in mind that each exchange prescribes the minimum number of shares in a transaction).

15 Upon further reflection, the staff thinks this is specific to IAS 39 and is not the case for the fair value of consideration transferred in a business combination under IFRS 3

Business Combinations (as revised in 2008), the fair value of an investment in a subsidiary in IAS 27 *Consolidated and Separate Financial Statements* (as revised in 2008) or the recoverable amount of an asset or a cash-generating unit in IAS 36 *Impairment of Assets*.

16 In each of these three situations, the unit of account is not an individual instrument.

IFRS 3

17 The fair value of consideration transferred in a business combination is calculated as the sum of the fair values of the assets transferred, liabilities incurred and equity interests issued by the acquirer (IFRS 3.37). The consideration transferred is measured as of the acquisition date, which is the date on which the acquirer obtains *control* of the acquiree.

18 The consideration transferred is commonly referred to as the purchase price for the acquiree. The purchase price reflects the price the acquirer paid to obtain control of the net assets of the acquiree, and included in the purchase price (usually) is a control premium.

19 The fair value of the assets transferred, liabilities incurred and equity interests issued reflects the fact that the acquirer has control over those items before the acquisition and the seller (the acquiree's shareholders) has control over them after the acquisition. On the other side of the exchange, the fair value of the tangible and intangible assets acquired assumes that the acquirer will have the ability to direct their use within the business.

20 Any difference between the purchase price and the fair value of the net assets acquired is goodwill. The basis for conclusions in IFRS 3 states that both the FASB and the IASB think goodwill qualifies as an asset, in part because the acquirer *controls* the benefits stemming from goodwill. The control of 'core goodwill' (see paragraphs BC313 and BC316 of IFRS 3) is provided by means of the acquirer's power to direct the policies and management of the acquiree. An acquirer is typically willing to pay for the ability to control the acquiree.

21 It is worth noting that paragraph 23 of FASB Statement of Accounting Standards No. 142 *Goodwill and Other Intangible Assets* (SFAS 142), after amendments resulting from FASB Statement of Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157), states:

> Measuring the fair value of a collection of assets and liabilities that operate together in a controlled entity is different from measuring the fair value of that entity's individual equity securities. An acquiring entity often is willing to pay more for equity securities that give it a controlling interest than an investor would pay for a number of equity securities representing less than a controlling interest. That control premium may cause the fair value of a reporting unit to exceed its market capitalization. The quoted price of an individual equity security, therefore, need not be the sole measurement basis of the fair value of a reporting unit. (SFAS 142.23)

22 A consequence of the Board's decision in September is that the control premium would need to be excluded from the purchase price and the measurement of the fair value of the net identifiable assets of the acquiree, resulting in a change in the measurement of goodwill. As noted above, the control premium represents the entire difference between the acquiree's pre-acquisition share price and the per-share transaction price. Embedded in that transaction price is a premium for control of the acquiree, along with other factors. Excluding control premiums in such situations would be inconsistent with US GAAP.

23 The Board's decision in September raises the following practical questions:

a Would an entity need to separate the premium for control from the other factors (eg those in paragraph 8) that result in a premium being paid?

b How would an entity go about removing the control premium from the purchase price?

c How would an entity go about removing the control premium implicit in the fair value of the net assets acquired (resulting in a change in the measurement of goodwill)?

IAS 27

24 A parent can present an investment in a in the parent's separate financial statements either at cost or in accordance with IAS 39 (generally at fair value) (IAS 27.38). The basis for conclusions in IAS 27 notes that the focus of separate financial statements is on the performance of the assets as investments. Paragraph BC66 states:

> The Board concluded that separate financial statements prepared using either the fair value method in accordance with IAS 39 or the cost method would be relevant. Using the fair value method in accordance with IAS 39 would provide a measure of the *economic value* of the investments. Using the cost method can result in relevant information, depending on the purpose of preparing the separate financial statements. [emphasis added]

25 'Economic value' is not defined in IFRSs. 'Economic value' is also used in the basis for conclusions in IFRS 3 and IAS 36. Presumably, the Board meant economic value to have a somewhat broader meaning than fair value, so that fair value is one example of an economic value, but not the only example.

26 The cost of an investment in a subsidiary would reflect any premium paid for obtaining control over the subsidiary. However, the Board's decision in September would mean that the fair value of the investment would not include a control premium. Rather, the fair value of the investment would reflect the sum of the fair values of the individual instruments comprising the investment.

27 Furthermore, the wording in paragraph 38 of IAS 27 refers to accounting for 'investments in subsidiaries', not accounting for 'the instruments that comprise the investment'. This implies that the unit of account is the investment, not the individual instruments.

28 The Board's decision in September raises the following practical questions (in addition to those in paragraph 23 above):

a Should the consolidated financial statements be presented on a different control basis from the separate financial statements (eg including a control premium on consolidation, but not separate, and vice versa)?

b Should there be a difference between the control basis of the cost of an investment and its fair value (eg including a control premium in cost but not in fair value)?

c Is the unit of account of an investment in a subsidiary in IAS 27 different from the unit of account for an individual instrument of that subsidiary?

IAS 36

29 The recoverable amount of an asset or a cash-generating unit is the higher of its fair value less costs to sell and its value in use.

30 As noted above, the fair value of an entity acquired in a business combination reflects the fact that the acquirer has control over that entity (and the underlying assets). Therefore, the fair value of the net assets acquired (including goodwill) reflects an implicit premium for control. It follows that the fair value of a cash-generating unit also reflects an implicit premium for control.

31 If the carrying amount of the assets comprising a cash-generating unit reflects a premium for control, the recoverable amount also must reflect the premium in order for the impairment test to be done on a like-for-like basis. Thus, the Board's decision in September could lead entities to 'back out' the control premium from the carrying amount of goodwill to compare it to a recoverable amount without the premium for assets acquired prior to the effective date of the fair value measurement standard (assuming the Board does not require retrospective restatement of past business combinations).

32 Furthermore, the wording in paragraph 104 of IAS 36 refers to the recoverable amount of the cash-generating unit, not the recoverable amount of the components (or the underlying instruments) that comprise the cash-generating unit. This implies that the unit of account is the cash-generating unit, not the underlying assets or individual instruments. If so, this is consistent with paragraph 23 of SFAS 142, as amended by SFAS 157.

33 The Board's decision raises the following practical questions:

a How would an entity go about removing the control premium implicit in the net assets acquired (including goodwill) in order to measure the recoverable amount of an asset or a cash-generating unit?

b Is the unit of account for a cash-generating unit different from the unit of account for the individual instruments underlying the cash-generating unit?

Summary

34 The staff thinks that blockage factors and control premiums are different, conceptually and practically. Unlike a blockage factor, a control premium is not related to liquidity or the entity’s intent.

35 The staff thinks that, consistent with the Board’s decision in September, the unit of account for a financial instrument is the individual instrument. However, in some cases (such as when an entity obtains control over another entity), there are additional elements included in the transaction price. In effect, the acquiring entity paid for the value of equity instruments of the acquiree and the value of control. The staff thinks the value of control should be reflected in a fair value measurement because market participants would (and do) pay for it, and they demand compensation for it upon sale. In other words, the unit of account might be the investment, not the individual financial instruments underlying the investment.

36 Having said that, the staff thinks an entity should not make an explicit adjustment for control when it is already embedded in a transaction price. For example, if an entity buys equipment for use in its production operations, the price paid includes an implicit premium for the fact that an entity has control over the asset and can use it or sell it as necessary as part of the business. If there are restrictions on the use of that asset, the entity would pay less for it.

37 The staff thinks each standard should specify the unit of account. In some cases, such as those mentioned in this paper, the staff thinks the Board should clarify the unit of account to ensure that entities do not ‘back out’ or add in adjustments. For example, the Board

could clarify whether the unit of account in IAS 27 is the investment or the individual financial instruments underlying the investment.

38 Once the unit of account is specified by a particular standard, an entity should apply the fair value measurement guidance consistently (ie by not double counting or leaving something out).

39 The exposure draft of an IFRS on fair value measurement guidance will refer to each standard for unit of account guidance. However, rather than explicitly precluding the application of blockage factors, the exposure draft could state:

> The unit of account for financial instruments is the individual instrument. As a result, the fair value of financial instruments within the scope of IAS 39 does not reflect the application of a blockage factor at any level of the fair value hierarchy.

Staff recommendation

40 The staff recommends that the Board require entities to include control premiums in the measurement of fair value, to the extent that market participants would pay such premiums on acquisition and require them on sale, when both of the following conditions are met:

a when an entity has or obtains control over an asset, a group of assets or an entity.

b when an IFRS specifies that the unit of account is not an individual financial instrument.

41 To do this, the staff recommends that the Board:

a clarify that its decision in September related to financial instruments within the scope of IAS 39; and

b specify that the decision was about adjustments that relate to the liquidity of a holding (eg blockage factors) and not to the liquidity of an individual instrument.

Questions for the Board

42 **Does the Board agree to clarify that the decision in September related only to financial instruments within the scope of IAS 39?**

   a **If not, should the exposure draft describe how an entity might adjust for a control premium, for example, when measuring the fair value of consideration transferred in a business combination in IFRS 3, the fair value of an investment in a subsidiary in IAS 27 or the recoverable amount of an asset or a cash-generating unit in IAS 36?**

43 **If the Board decides to clarify that the decision in September related only to financial instruments within the scope of IAS 39, does the Board agree to specify that the decision in September was about adjustments that relate to the liquidity of a holding (eg blockage factors) and not to the liquidity of an individual instrument?**

   a **If not, should the exposure draft describe how an entity might adjust for a control premium, for example, when measuring the fair value of consideration transferred in a business combination in IFRS 3, the fair value of an investment in a subsidiary in IAS 27 or the recoverable amount of an asset or a cash-generating unit in IAS 36?**