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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**18 September 2008, London**
Project:	**Fair value measurement**
Subject:	**Blockage factors in a fair value measurement (Agenda Paper 3B)**

Introduction

1 At the June 2008 IASB meeting, the staff asked the Board to reaffirm some of its preliminary views as articulated *Fair Value Measurments* discussion paper. We asked for reaffirmation on issues for which:

a the requirements in FASB Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157) are broadly consistent with the requirements currently in IFRSs; and

b the issue was not particularly contentious among constituents, based on the comment letters received on the discussion paper and through other means.

2 One of the preliminary views for which we asked for reaffirmation related to the prohibition on blockage factors. Some Board members noted that very few respondents agreed with the Board's preliminary view and for that reason the Board should discuss it further.

3 Other Board members noted the following:

a the discussion paper gave constituents the opportunity to criticise fair value measurement requirements that they do not like in IFRSs (and the blockage prohibition is one of them); and

b the volume of comments in favour or against a particular issue is not sufficient to indicate that the Board 'has got it wrong'. Rather, an issue should be reconsidered only if new information or arguments are identified.

4 This paper contains:

a an overview of the requirements in SFAS 157;

b an overview of the requirements in IAS 39 *Financial Instruments: Recognition and Measurement*;

c the Board's preliminary view as articulated in the *Fair Value Measurements* discussion paper; and

d the staff's analysis and recommendations.

5 Please note:

a this paper focuses only on blockage discounts, **not** on other discounts or premia that might be applied in a valuation.

b references in this paper to 'the individual instrument' refer to the normal market size represented by the quoted market price. The normal market size represents the number of shares that a market maker can trade at the quoted price. Each exchange has different way of calculating a normal market size.

SFAS 157 and IAS 39 requirements

SFAS 157 requirements

6 With regard to instruments in Level 1 of the fair value hierarchy (quoted prices for identical assets in an active market) SFAS 157 states:

> If the reporting entity holds a position in a single financial instrument (including a block) and the instrument is traded in an active market, the fair value of the position shall be measured within Level 1 as the product of the quoted price for the individual instrument times the quantity held.

> The quoted price shall not be adjusted because of the size of the position relative to trading volume (blockage factor). The use of a blockage factor is prohibited, even if a market's normal daily trading volume is not sufficient to absorb the quantity held and placing orders to sell the position in a single transaction might affect the quoted price.[1] [SFAS 157.27]

7 The basis for conclusions on SFAS 157 provides the following reasons for this decision:

- a using quoted prices increases comparability because:
  - i adjusting the price for the size of the position introduces management intent (to trade in blocks) into the measurement, reducing comparability; and
  - ii holding a relatively large amount of an asset might sometimes result in a premium over the market price for a single trading unit;
- b the decision to exchange a large position in a single transaction at a price higher or 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;
- c 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; and
- d adjusting the price is subjective and reduces the reliability of the fair value measurement. The American Institute of Certified Public Accountants' Accounting Standards Executive Committee (AcSEC) blockage factor 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.

[1] The guidance in this Statement applies for positions in financial instruments (including blocks) held by all entities, including broker-dealers and investment companies within the scope of the AICPA Audit and Accounting Guides for those industries.

8 The FASB decided not to specify the unit of account for an instrument that trades in a market that is not active. As a result, blockage factors are allowed for financial instruments in Level 2 and Level 3 of the fair value hierarchy.

IAS 39 requirements

9 IAS 39 states ‘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’ (paragraph AG72). This is under the section ‘Active market: quoted price’ (and is not under ‘No active market: valuation technique’), leading some constituents to think that the prohibition on blockage factors applies only when there is a quoted price in an active market for a financial instrument.

10 Some argue that this is confirmed by the guidance in paragraph AG75, which states, ‘The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm’s length exchange motivated by normal business considerations’. Paragraph AG75 could be interpreted to mean that if the transaction price would reflect a blockage discount (or a premium), the valuation technique should include it.

11 The basis for conclusions in IAS 39 states:

> …the Board confirmed that a quoted price is the appropriate measure of fair value for an instrument quoted in an active market, notably because (a) in an active market, the quoted price is the best evidence of fair value, given that fair value is defined in terms of a price agreed by a knowledgeable, willing buyer and a knowledgeable, willing seller; (b) it results in consistent measurement across entities; and (c) fair value as defined in the Standard does not depend on entity-specific factors. [IAS 39.BC97]

Board’s preliminary view in the discussion paper

12 The Board’s preliminary view in the *Fair Value Measurements* discussion paper was that a blockage factor adjustment should be prohibited at all levels of the hierarchy. The rationale for this was as follows:

> The Board observes that blockage factors are often meant to adjust for the illiquidity of a large position of financial instruments that might be held by an entity. However, the illiquidity of an individual instrument is

> not affected by the size of a position held by an entity. If a financial instrument is not traded in an active market and the illiquidity affects the price that a market participant would pay for an individual financial asset or require for an individual financial liability the fair value measurement should reflect that illiquidity. However, the adjustment should not consider the size of the position held by the entity.

Staff analysis

13 The objective of a fair value measurement is to reflect the price at which a transaction would occur between market participants on the measurement date. Many who disagree with the prohibition of blockage discounts do so because they think that, without it, the value does not reflect the amount for which an entity could sell its holding.

14 The New York Stock Exchange defines a block as 'a large holding or transaction of stock. Generally 10,000 or more shares or any quantity worth over $200,000 is considered a block'. The AcSEC's blockage factor task force report (referred to in the SFAS 157 basis for conclusions) states that 'in practice a block was always larger in size [than 10,000 shares] and is determined based on the size of the position compared to [the] security's average trading volume rather than based on the size of the position itself. Generally, a block refers to a position greater than 1,000,000 shares'.

15 A blockage discount represents a discount to the quoted price of an instrument (usually equity securities) to reflect the reduction in the price if the entity were to sell a large holding of instruments at once.

16 In a valuation involving blockage discounts, the following should be considered about the ways a particular block of shares could be sold:[2]

- a a private placement;
- b in small quantities in the market such that the sales are not expected to affect the market price;
- c to an underwriting syndicate for resale to the public;

[2] From Pratt, Shannon P., *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 5th Edition.

d through a broker, who might buy the entire block and resell it; or

e exchange distributions (one party sells a block to other members of the exchange who have solicited purchases).

17 Discussions about blockage factors centre around the following issues, each of which is discussed below:

a whether the unit of account is the individual instrument or the holding;

b whether entity intent factors into the measurement; and

c whether blockage factors result in liquidation values.

Unit of account

18 If the unit of account is a single instrument, a blockage discount would not be appropriate and should not be included in the measurement. But if the unit of account is the holding, it seems that it should be included.

19 The FASB has specified that the unit of account, at least in Level 1 of the hierarchy, is the individual instrument. Similarly, IAS 39's unit of account is the individual instrument when there is an active market for the financial instrument.

20 The staff thinks the issue is not that the unit of account is specified, but rather that the unit of account is a **consequence** of the decision to prohibit blockage factors. If the unit of account were to be specified, it seems that it should be the same for all financial instruments, regardless of the level within the hierarchy.

Entity intent

21 Discussions about blockage factors often focus on the various ways in which an entity **intends** to sell its holding of a group of financial instruments. For example:

a the entity **plans to** sell them in a block; or

b the entity **plans to** sell them individually over time.

22 Whether the entity intends to sell the block today or the individual instruments over time depends on the entity's business model—that is, it depends on why it is holding the block of instruments:

a some entities hold blocks with the intention of selling the instruments as a block, either on the exchange or outside the exchange (eg in the principal-to-principal market). Such entities assert that their holding should reflect a discount to reflect the decline in market price that they expect to realise if they were to exit the position on the measurement date.

b other entities buy blocks with the intention of selling the instruments individually over time.

c still other entities hold them with the intention of maintaining a strategic investment. Such entities think their holding should reflect a premium to reflect the strategic decision to retain the holding and use it, for example, to influence the investee management's decisions (eg a strategic premium or a control premium). Such situations are outside the scope of this paper.

23 This raises the following questions:

a should the application of a blockage factor depend on whether the entity plans to sell the holding or to keep it?

b what size holding is considered a block? A percent of shares outstanding? A percent of daily trading volume? Does it differ by exchange?

24 The staff thinks it would be difficult to create a principle for a fair value measurement that reflects the entity's intentions in some circumstances, but not in others (eg management's intent is not considered in an assessment of the highest and best use for land).

Liquidation values

25 Discussions about blockage factors also focus on reasons an entity **has to** sell its holding of a group of financial instruments. For example, sometimes an entity **has to** sell them in a block because it has to exit the entire holding today. If an entity does not **need to** sell today, it seems it would sell the instruments individually over time so as

not to depress the price (which is about the entity's intent, although it could be argued that no rational market participant would sell at the lower price).

26 To draw on guidance given in another context, the US tax estate tax regulations state the following about applying blockage discounts for securities:

> **In certain exceptional cases**, the size of the block to be valued in relation to the number of shares changing hands in sales may be relevant in determining whether selling prices reflect the fair market value of the block of stock to be valued. If the executor can show that the block of stock to be valued is so large in relation to the actual sales on the existing market that **it could not be liquidated in a reasonable time without depressing the market**, the price at which the block could be sold as such outside the usual market, as through an underwriter, may be a more accurate indication of value can market quotations… [US Estate Tax Reg. Sec. 2031-2(b)(1); emphasis added]

27 Underlying the notion of a fair value measurement is the requirement that the transaction be orderly:

a SFAS 157 defines an orderly transaction as one that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (eg a forced liquidation or distress sale).

b IAS 39 states that a fair value assumes that an entity is a going concern without any intention or need to liquidate or to undertake a transaction on adverse terms.

28 The staff thinks 'exposure to the market for a period prior to the measurement date' implies that the market has begun to absorb (or anticipate absorbing) the instrument and that they are not all being sold on one day. This means that enough time has elapsed such that the usual and customary marketing activities have occurred so as not to influence the price of the asset or liability.

29 It seems an entity would sell at a discount only if it needed do so. If an entity needs to sell the entire holding at once this is an example of a forced sale or liquidation. The price in such a transaction is not a fair value. An entity might also be compelled to sell a holding all at once for strategic reasons, which would be entity-specific.

30 A rational market participant will sell the instruments over time so as not to depress the price unless for some reason it is forced to sell today.

31 Furthermore, blockage discounts could be seen as an attribute of the transaction, not the holding. The resulting discount upon sale of the entire block is akin to a transaction cost.

Blockage discounts in Levels 2 and 3

32 Although many entities do not agree with the prohibition of blockage factors (or other discounts and premia) in Level 1 of the fair value hierarchy, they have come to accept it as an accounting ‘rule’. However, many do apply blockage discounts (as well as other discounts and premia) in Levels 2 and 3. **This paper focuses only on blockage discounts, not on other discounts or premia that might be applied in a valuation.**

33 In Level 2, when using prices for identical assets in inactive markets, perhaps it could be argued that a blockage discount is warranted because the trading volume in the instrument is not sufficient to absorb the sale of a large holding, even over a long period.

34 In Level 3, there is no observable market in which to make the trade. As a result, there is no observable market price that could be depressed, although a buyer might take into account the illiquidity of the instruments in negotiating the price. Therefore, technically there cannot be a blockage discount in Level 3.

35 The staff thinks the rationale above about entity intent and liquidation values applies at all levels of the hierarchy. Regardless of the observability or level of trading activity, an entity is unlikely to sell at a loss in the amount of the blockage discount unless it is forced to sell, which by definition is not a fair value.

Disclosures

36 If the Board reaffirms its preliminary view in the discussion paper to prohibit blockage factors at all levels of the hierarchy, it could require or encourage entities that hold blocks in a single instrument to disclose the amount at which it could realise today from the sale of that block (eg the current exit price), including a blockage factor, if that amount is different from the amount in the statement of financial position. The disclosure also could include the policy for defining and measuring blocks. However,

the staff understands that this could be commercially sensitive information. In addition, some might find that a disclosure of this kind would add little value.

37 The staff notes that, even if entities are not required to disclose this information, they can disclose it if they think it provides decision-useful information to users of financial statements.

Summary and staff recommendation

38 The objective of a fair value measurement is to reflect the price at which a transaction would occur between market participants on the measurement date. If market participants would consider discounts or premia in setting the price, this objective would result in a fair value measurement reflecting such an adjustment. The staff thinks the objective applies to all levels of the fair value hierarchy.

39 The staff thinks, in many cases, this does not apply to large blocks of instruments. It is important to note that the level of the hierarchy is indicative of the unit of account. SFAS 157 states that a fair value measurement might fall within Level 1, Level 2 or Level 3 depending on the inputs that are significant to the measurement in its entirety and the level in the fair value hierarchy within which those inputs fall. Therefore, if there is an observable market price for an instrument and that price is significant to the fair value measurement, that price should be used. If there is an observable market price, it follows that the entity can sell the individual instrument separately (even if it does not intend to do so). This would generally be the case for instruments with Level 1 and Level 2 quoted prices. This means that the unit of account for Level 1 and Level 2 (with regard to instruments measured using Level 2 quoted prices) is the individual instrument.[3]

40 In Level 3 of the hierarchy, there is not an observable market price, either for an individual instrument or for a group of instruments. An entity must determine whether it can sell its holding (not whether it **will** or it **plans to**, but whether it **can**) in the aggregate or if it can sell it unit by unit over time. It might be the case than an entity would not be able to find a buyer for each individual instrument over time. However,

[3] Level 2 comprises quoted prices and other observable inputs. This paper focuses on the Level 2 inputs that are quoted prices.

blockage factors are not relevant to Level 3 because there is no observable market price to depress.

41 The principle is that, in all levels of the hierarchy, the fair value measurement objective is to reflect the price at which a transaction would occur between market participants on the measurement date. If there is an observable price for an individual instrument, and that instrument can be sold in isolation (even if the entity does not intend to do so), and the price is a significant input to the fair value measurement, that price should be used and the resulting measurement reflects the holding of a single instrument. In such a case, 'the transaction' in the fair value measurement objective is the transaction for an individual instrument. If the entity can only sell the holding and not each individual instrument, 'the transaction' is for the holding and the fair value should reflect the price market participants would pay for the holding.

42 The consequences of this are as follows:

a **Level 1 and Level 2 quoted prices:** an entity must use a Level 1 or Level 2 quoted price to measure the smallest holding for which the entity could sell the individual instrument on the measurement date. The exposure draft could state that it would be extremely rare for an individual instrument with a quoted price to be adjusted for a blockage factor.

b **Level 2 and Level 3 inputs that are not quoted prices:** when using Level 2 and Level 3 inputs that are not quoted prices, an entity will assess whether market participants would sell in a block or each individual instrument to maximise the price. Technically, the entity would not apply a blockage factor per se because there is no observable market price that can be depressed.

43 As stated previously, this paper is only about blockage factors, not other discounts and premia. This paper does not mean to imply that an entity would not apply, if relevant, a control premium on the holding or a liquidity adjustment on the individual instrument.

44 This is consistent with the Board's preliminary decision in the *Fair Value Measurements* discussion paper. It is also consistent with the Board's tentative decision in developing the discussion paper *Reducing Complexity in Reporting Financial Instruments*. In November 2006 the Board tentatively decided that the

measurement objective should be to measure fair value at the individual instrument level. However, this requirement would not prevent an entity from aggregating similar items into a portfolio and measuring the portfolio, as long as the objective in doing so was to estimate the total fair value of the individual instruments within that portfolio.

45 If the Board agrees with the staff's recommendations above, the staff does not recommend requiring disclosures about the adjustments used and the policy for such adjustments.

Questions for the Board

46 Suppose that (a) there is an observable, quoted price for an instrument, (b) that price is a significant input to the fair value measurement, and (c) the instrument can be sold in isolation (even if the entity does not intend to do so). This instrument falls in Level 1 or Level 2 (quoted prices) of the fair value hierarchy. Do you agree that the observable price should be used without an adjustment for the size of the holding (ie a blockage factor would not be applied)?

47 Suppose that there is not an observable, quoted price for the instrument. This instrument falls in Level 3 of the fair value hierarchy. Do you agree that blockage factors are not applicable in Level 3 because there is no observable market price to depress?

48 If you do not agree with either of the above questions, which do you prefer:

a to prohibit blockage discounts in all levels of the fair value hierarchy; or

b to prohibit blockage discounts only in Level 1 of the fair value hierarchy; or

c to require blockage discounts, when applicable, in all levels of the fair value hierarchy?

49 Do you agree that entities should not be required to disclose information about the adjustments made, if any, to a fair value measurement when there is an observable, quoted price?