

MINUTES



Financial Accounting Standards Board

To: Board Members

From: Financial Instruments—Fair Value Team (Nesta, ext. 330) **Time Code:** A FI-FV

Subject: Minutes of the January 8, 2003 Board Meeting **Date:** January 10, 2003

cc: Bielstein, Leisenring, Smith, Petrone, Swift, Polley, Project Team, Thompson, FASB Intranet (e-mail), Vincent, Sutay, Gabriele

Topic: Use of Block Discounts in Valuing Unrestricted Equity Securities

Basis for Discussion: Staff memorandum dated December 26, 2002

Length of Discussion: Starting Time: 9:00 a.m.
 Concluding Time: 10:15 a.m.

Attendance:

Board members present: Herz, Crooch, Foster, Schieneman, Schipper, Trott, Wulff

Board members absent: None

Staff in charge of topic: McKenna

Other staff at Board table: Bielstein, Metcalfe, Nesta

Outside participants: Jim Johnson, AICPA Block Discount Task Force Chair

SUMMARY OF DECISIONS REACHED

The Board discussed matters related to the issue of whether block discounts should be considered in determining the fair value of a block of identical equity securities for which there is an observable market price. The Board decided that an entity is required to use a block discount to measure the fair value of unrestricted equity securities when the entity has a demonstrated history of buying and selling blocks of unrestricted equity instruments and when the size of the discount can be measured with sufficient reliability. [4 Board members agreed: RHH, JKW, GMC, GSS; 3 did not: KAS, JMF, EWT]

MATTERS DISCUSSED

Ms. McKenna opened the discussion by stating that the AICPA's Block Discount Task Force has exerted considerable effort researching block discounts and has concluded that the application of block discounts (i.e. when to take a discount and how large the discount should be) is subjective and is generally based on judgment and experience. She added that the task force also was unable to identify a generally accepted method for quantifying the appropriate amount of a block discount. Instead, it has identified one primary factor and several secondary factors that constituents generally cited in considering block discounts.

She stated that the staff has recommended that the Board disallow block discounts because the staff believes the concept of block discounts does not conform to the measurement decisions the Board has made to date, namely, the concept of most-advantageous price, the definition of "reasonable access" to a market, and disallowing intent-based accounting.

She then requested that the Board either deliberate and vote on the issues included in the staff's memorandum today or articulate the additional questions that require answering to enable the staff and the task force to proceed with their research as effectively as possible.

Ms. Schipper supported the staff's recommendation and stated that she was troubled by paragraph 29 of the paper entitled "Summary of AcSEC's Views on the Use of a Block Discount to Value an Unrestricted Security That Has a Quoted Market Price," that states:

AcSEC concluded that the following relationship is a key factor in determining whether a block discount is required and correlated with the size of a block discount:

- Market capitalization of the company in which the equity investment is held, in relation to
- The size of the block to be traded (expressed as a percentage of the average daily trading volume)

This relationship represents a current gauge of the position's liquidity, the more liquid the position, the less significant the discount and vice versa.

Ms. Schipper noted that the staff emphasized preparer difficulties in reliably measuring block discounts, and stated that she didn't find paragraph 29 helpful in alleviating those difficulties.

Mr. Trott stated that he believes that the issue of block discounts is a unit of measure question. He stated that the Board has recently issued pronouncements that require an entity that forgoes its most advantageous price to recognize that event when it occurs. He stated that if a seller of blocks is not legally precluded from selling the shares in smaller groups than the block, then that seller is forgoing its most advantageous price. To be consistent with prior pronouncements, the entity's failure to obtain the most advantageous price should be recognized when the sale is made and not prior to it. He noted, though, that he is troubled by the result when an entity purchases shares in a block at a discount to the observable market price and then recognizes an immediate gain on the date of purchase when the block is marked to market.

Mr. Foster supported the staff's recommendation and stated that if the Board decides not to allow the use of block discounts then the basis for conclusions could acknowledge that Board members believe block discounts do exist but that the Board decided to require the unit of measure to be the individual share as opposed to a block of identical shares. He added that Board member concerns about reliability of block discount measurements and block discounts being an intent-based measurement could also be included.

Mr. Herz stated that he supports the use of block discounts because he believes their use results in a more relevant fair value measurement than multiplying the market price per share times the number of shares because the holder of the block never intends to realize the gain it could achieve by selling at the quoted market price. He noted that entities should not be allowed to have a free choice in determining when to use a block discount and that the entity should have a demonstrated history of buying and selling shares in blocks to be allowed to use a block discount in valuing unrestricted equity securities. He added that entities that take block discounts should be able to measure those discounts with sufficient reliability. He then asked who would support his proposal to allow block discounts over the proposal offered by Mr. Foster which acknowledged

the existence of block discounts but explained the reasons why the Board believes that they should not be allowed to be taken. [4 Board members agreed with Mr. Herz's proposal: RHH, JKW, GMC, GSS; 3 did not: KAS, JMF, EWT]

All Board members acknowledged that block discounts do exist in practice. Those Board members who decided to allow block discounts generally believe that an entity that is able to demonstrate a past history of buying and selling unrestricted equity securities in blocks should be allowed to take a block discount. The assenting Board members conditioned their allowance of block discounts in those limited situations on the entity's ability to develop a sufficiently reliable methodology for measuring block discounts.

Mr. Wulff stated that he supports the use of block discounts because he believes that the unit of accounting is always the portfolio, not the individual securities that make up the portfolio. He stated that a portfolio of identical securities has different risks and rewards than an individual security within the portfolio, and that the observable market price less any applicable block discount is the most relevant measurement of that portfolio.

Mr. Schieneman stated that he believes the issue of block discounts is not very significant for broker-dealers because in his experience both the volume of block trading and the size of block discounts was immaterial. He added that users of financial statements think that fair value represents net realizable value. He stated that allowing the use of block discounts would be consistent with users' notions of fair value as net realizable value.

Mr. Crooch stated that he believes block discounts should be allowed to be taken provided that guidelines exist to ensure the reliability of the measurement and to ensure that entities that use block discounts in their valuations have an established history of buying and selling in blocks. He noted that Mr. Herz's proposal, if drafted properly, would provide those guidelines.

FOLLOW-UP ITEMS

- The Board directed the FASB staff and the AICPA Block Discount Task Force to work together to draft language that articulates the Board’s decision to allow the use of block discounts in valuing unrestricted equity securities that have quoted market prices.
- The Board also directed the staff to explore redefining the term “restricted stock.” Restricted stock is currently defined under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.

GENERAL ANNOUNCEMENTS

None.