THE NEW FAIR VALUE ACCOUNTING RULES ELIMINATE BLOCKAGE FACTORS AND MAKE OTHER COMPLEX CHANGES THAT PRESENT CHALLENGES AND OPPORTUNITIES FOR VALUATION PROFESSIONALS.

AMENDED FAIR VALUE ACCOUNTING RULES CREATE COMPLEX CHALLENGES

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The most significant changes to fair value accounting rules since the Financial Accounting Standards Board (FASB) released SFAS No. 157 in 2006 are now fully in effect, with calendar-year companies required to comply with them for the reporting period that ended on 3/31/12. But the full impact of the amendments is still not widely understood, even by many valuation professionals. Accounting Standards Update (ASU) No. 2011-04,[1] issued in May 2011, is more than 300 pages long and includes complex changes to how valuations must be carried out and disclosed.

In line with the gradual blending of U.S. and international accounting rules, the new ASU is a joint effort with the International Accounting Standards Board (IASB), which issued International Financial Reporting Standards (IFRS) 13, *Fair Value Measurement*, in May 2011. It brings the U.S. generally accepted accounting principles (GAAP) and the IFRS standards for "fair value" closer together, although differences between the two still remain.

The most important changes in the ASU include:

- Elimination of blockage discounts for Level 2 and Level 3 assets.
- Previously, certain assets could be valued on a portfolio basis. Now, rather than valuing these assets as a group, valuation professionals and their clients will have to value each asset on an individual basis. Large financial institutions especially will be affected by this change.
- The new rules introduce a complex new exception to the requirement that assets be valued on an individual basis. The exception applies to measurements with offsetting risks. Specific criteria must be adhered to in order to apply the exception.
- Financial reporting entities will have to deal with new disclosures and process changes.

The ASU is effective for public companies in fiscal years beginning after 12/15/11, including interim periods. It must be applied on a prospective basis; retrospective application is not allowed. Any change in fair value measurements should be recorded as a change in estimate in the income statement in the reporting period of initial application. Changes in valuation techniques and measurement inputs also should be quantified and disclosed.

This article explains the new ASU and provides guidance in the following areas:

- *Premiums and discounts.* The ASU provides new guidance on the application of certain premiums and discounts to financial instruments held, including disallowing the use of blockage factors, except when a "portfolio exception" applies.
- *Financial instruments with offsetting risks.* For financial instruments with offsetting market or credit risks to qualify for the portfolio exception, certain fair value measurements of financial assets and liabilities must be based on their net positions.
- *Unit of account.* The unit of account is the level at which a fair value measurement must be performed. Compared with previous guidance, the ASU places greater emphasis on the unit of account concept. It requires that the fair value of financial instruments be measured based on the level of the unit of account, instead of taking an aggregated (or disaggregated) approach.

The End of Blockage Factors—Except for the Exception

The change that may have the greatest impact on asset valuation is the elimination of blockage factors for fair value measurement.

A blockage factor is a discount applied in measuring the value of a security to reflect the impact on its value of selling a large block of the security at one time. Although a financial firm might sell a large block of a particular security at a lower per share price than a smaller block of the same security, the FASB no longer recognizes the economic difference between selling a large block and selling a small block.

Blockage factors were never allowed for Level 1 fair value measurements, but before the ASU they could be considered for Level 2 and Level 3 measurements. Under the new rule, the use of blockage factors is eliminated, with one exception, called the "portfolio exception," which is discussed below.

Before the ASU, certain financial instruments that were grouped together for trading purposes might qualify to be valued on a portfolio basis. This is no longer allowed. Financial instruments must now be valued at the unit of account level specified in other guidance, which may often be all the way down to the individual security level. This will represent a big change for some companies, such as investment and private equity firms with non-controlling blocks of equities.

The "highest and best use" and valuation premise concepts for financial assets are also eliminated. The "highest and best use" concept established the valuation premise used to measure the fair value of the asset. Financial assets had two possible valuation premises: "in use" and "in exchange." In-use assets are valued as a group, while in-exchange assets are valued on an individual basis.

Before the ASU, companies often applied an "in use" valuation premise under the "highest and best use" concept when measuring the fair value of financial instruments. This allowed companies to look at how they trade and manage securities, and value them accordingly. For example, financial assets and liabilities that trade in homogenous pools are often grouped together when measuring fair value.

Under the ASU, the grouping of financial assets under an in-use valuation premise is not permitted. Fair value must be measured at the unit of account level called for under other guidance, which often means at the individual share level.

In cases where the bid-ask spread is used to price a security, the price within the spread that is considered most representative of fair value should be used. Selecting a price within the bid-ask

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spread that is meant to reflect an adjustment for the size of the holding is not allowed under the ASU, nor is taking the view that the bid-ask spread is wider for larger positions.

Companies may now face immediate recognition of a gain if a block of securities was purchased at a discount and the company is unable to apply a blockage factor. Realizing that gain would depend on whether the company sells the securities at a discount in the future.

Premiums and Discounts. The ASU restricts the circumstances under which premiums and discounts can be applied, separating entity-specific premiums and discounts from those that relate to the characteristics of the asset or liability being valued. As a result, blockage factors may no longer be allowed, but control premiums are allowed. A control premium is applied when the investment's value is enhanced as a result of maintaining a controlling interest in an investee.

While a blockage factor is considered to be an entity-specific characteristic, a control premium is considered to be a characteristic of the asset or liability, and is still permitted. Blockage factors are akin to transaction costs, which are not permitted in a fair value measurement, since they result from entity-specific transaction decisions.

A control premium is appropriate when individual securities within a block have more value due to the block having a controlling interest. The ability to control enhances each of the individual underlying securities held. For a Level 2 or Level 3 fair value measurement involving individual securities that, as a block, have a controlling interest, a market participant would likely pay a premium to obtain control. If a company holds a block of securities with a controlling interest, a market participant would not be expected to sell the securities piecemeal and sacrifice the benefit of the controlling interest.

Shares that create a controlling interest are worth more than shares that do not create a controlling interest. For example, assume a company's shares trade at $20 a share and the company has 1 million shares outstanding. Although the market capitalization is $20 million, an acquirer purchasing 80% of the shares would typically be willing to pay a premium of perhaps 30% over that amount to gain a controlling interest. Instead of having a value of $16 million, the 80% stake could be worth $20,800,000.

It is possible to have a day one gain from purchasing a block of securities at a discount, but not a day one loss by purchasing at a premium a block of securities that held a controlling interest.

Companies should still consider the following factors when deciding whether it is appropriate to apply a discount or a premium:

1. *Market participant assumptions.* A core principle of the fair value guidance is that a fair value measurement is determined based on the assumptions that market participants would use to price the asset or liability being measured, rather than entity-specific assumptions, such as those of the entity reporting the valuation on their books. Before a determination can be made about whether a market participant would make an adjustment for that assumption, the assumption must first be analyzed and deemed to be a characteristic of

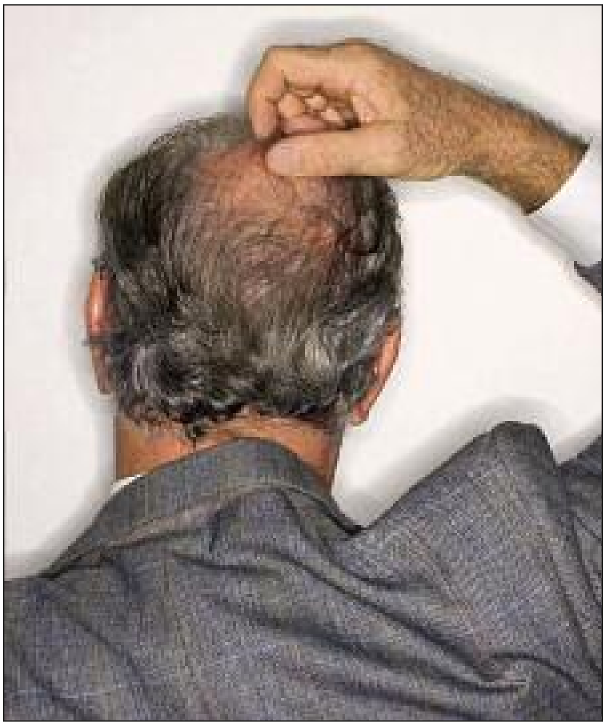
1 "Fair Value Measurement (Topic 820), "Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS," FASB.

the asset or liability. Each assumption used must not only be one that would be considered by market participants, it must also be one that is deemed a characteristic of the asset or liability being measured, rather than a characteristic of an entity. Market participants are assumed to transact in a manner that is in their economic best interest. Therefore, under the new guidance, an entity would continue to incorporate premiums or discounts (except for discounts or premiums related to size, such as blockage factors) in a Level 2 or Level 3 fair value measurement, if market participants would do so.
2. *Unit of account as defined by other guidance for the asset or liability being measured.* While the determination of fair value is rooted in market participants' assumptions, it cannot contradict the unit of account for the asset or liability being measured under the new guidance. FASB Accounting Standards Codification Topic 820 (ASC 820) does not define the unit of account for any asset or liability. Rather, unit of account is based on other guidance.
3. *Unit of measurement* (see the "portfolio exception" below regarding the exception provided for portfolios of financial instruments with offsetting market and/or credit risks). ASC 820 provides guidance on the unit of measurement in the case of the portfolio exception.
4. *Premium or discount calculations.* Whether the premium or discount is related to the size of the entity's holding of the asset or liability, or is reflective of a characteristic of the asset or liability itself.
5. *Impact of the premium or discount.* Whether the impact of the premium or discount is already contemplated in the valuation.

The ASU does not specify what types of premiums or discounts should still be considered, but some examples may include:

1. Lack of marketability discounts.
2. Non-controlling interest discounts.
3. Premiums or discounts related to cash-flow uncertainty.
4. Premiums for significant influence for an equity method investment accounted for under the fair value option (FVO).
5. Premiums when making an impairment assessment of an equity-method investment.
6. Adjustments for default or collateral risk related to holdings in mortgage-backed securities.

More specifically, a control premium may apply to a block of securities held by an investment company if the block has a controlling interest that a market participant would consider. Other discounts and premiums may also apply. A control premium is not applicable, though, to a block of securities held by any other type of company, as the investment would be consolidated. However, other discounts and premiums may apply.



In an equity method investment for which the FVO is elected, a control premium is not applicable, because there is no control. Different discounts and premiums, such as a premium for significant influence, may apply.

In valuing derivatives, typical discounts that may apply include discounts for illiquidity and certain risks. For certain derivatives, if a company manages its market and counterparty credit risks within a portfolio on a net basis, the "portfolio exception" should be considered.

The Portfolio Exception

The portfolio exception is available on an election basis and there are hurdles to qualify. The exception allows companies to measure fair value based on the net position of the portfolio, instead of the individual positions within the portfolio. An example of this is the price that would be received to sell a net long or net short position for a particular market or credit risk exposure.

The portfolio exception exempts companies from having to measure at the unit of account level proscribed by other GAAP. Without the exception, aggregation or offsetting of instruments to determine fair value is not allowed.

When the portfolio exception is elected, the unit of measurement becomes the net position of the portfolio, and size becomes a characteristic of the portfolio. The securities are valued based on the price that a market participant would pay to purchase the whole portfolio in one transaction. An adjustment based on size is allowed if it would be applied by market participants. Therefore, if the portfolio election is properly made, instruments can still be grouped together for a fair value measurement and blockage factors can still be applied.

The qualification requirements for the portfolio exception are based on how a company manages the portfolio. To qualify, a company must:

1. Manage the group of financial assets and liabilities on a net basis; that is, the basis of the company's net exposure to a specific, identified market or counterparty risk.
2. Report information to management about the group of financial assets and liabilities on a net basis.

The portfolio must be scoped into FASB Accounting Standards Codification Topic (ASC) 815, *Derivatives and Hedging*, and ASC 825, *Financial Instruments*, before these two conditions can be considered. As such, the portfolio exception is designed for financial assets and liabilities that must be assigned a fair value on a recurring basis, either because the FVO was elected or because fair value is required. It has to be scoped into both rules to qualify. For example, a physically settled commodity derivative contract would generally not meet the definition of a financial instrument.

As described above, nonfinancial instruments are currently excluded from the portfolio exception. The FASB has indicated this exclusion was not intentional and will be corrected. Whether a reporting period or two will pass before the correction is made is unknown.

The concepts of the valuation premise and "highest and best use" may still be considered for nonfinancial instruments. The FASB's correction will probably address portfolios that contain a mix of financial and nonfinancial instruments. For example, some banks have physically-settled commodity contracts that are managed together with cash-settled derivatives.

Some financial instruments are not measured at fair value on a recurring basis. Others are assigned a fair value on a recurring basis, but only the amounts are disclosed and they are not reported on the balance sheet. Such instruments would not qualify for the portfolio exception.

To adopt an accounting policy that permits the portfolio exception, companies need to support their assertion that the portfolio is managed based on the company's net exposure to market risk or credit risk. Examples of support include documentation of the company's risk management and investment policies, meeting minutes, and management reports. It is important to think about what the company has done in the past and make sure it is consistent with the support. The exception must be applied consistently from period to period and from business unit to business unit.

Companies should document at each reporting period whether risk exposures continue to be managed on a net basis. The election is not irrevocable. If a company's risk exposure preferences change, it can be required to cease using the exception. Such changes are expected to be rare and infrequent.

The portfolio exception does not deal with financial statement presentation. Whether an instrument can or must be presented on a net or gross basis in the financial statements is a separate determination, driven by other guidance. It is possible to have a difference such as when the portfolio exception allows grouping for fair value measurement purposes, but an allocation to a more granular level is required for financial statement presentation purposes. For example, a portfolio of financial instruments that is managed within a group may be determined based on the net position when using the portfolio exception, but at the same time the company is required to allocate the resulting fair value based on the unit of account required by other guidance for those same instruments.

The new ASU does not provide any allocation guidance. Any allocation of the fair value of a portfolio of financial instruments to a lower level of detail should be done in a reasonable and consistent manner.

Managing on a Net Basis. As mentioned previously, to qualify for the portfolio exception, a group of financial assets and liabilities must be managed on a net basis, and information must be reported to management on a net basis. This means the portfolio must be managed on the basis of the company's net exposure to market risk or counterparty risk.

Offsetting Positions. If a company enters into an offsetting position with the portfolio exception in mind, it should be careful to ensure that the position has substance. Managing a portfolio based on Value at Risk (VaR), for example, does not guarantee that the portfolio is being managed on a net basis.

To meet this requirement, the market risks that are being offset must be offset in an acceptable manner. The ASU does not say how much of a long or short position needs to be offset to qualify. As long as a company's risk and investment strategies are in sync with the nature of the portfolio being managed, 100% offset is not required. If the offset does not occur on the measurement due date, the portfolio exception can still be used, as long as the lack of offset can be shown to be temporary and the cause of the lack of offset was related to unexpected market events or other circumstances.

Duration is another important factor. The market risk being offset must have substantially the same duration. When portfolios have offsetting positions with different maturities, fair value adjustments to the net portfolio position should be made to account for duration mismatches.

Companies should be aware of any positions in the portfolio with maturity differences, because they will result in an adjustment to the net position. For example, in a portfolio of interest rate swaps with long positions of 25 years to maturity that are offset with short positions of 15 years to maturity, the ten years of unmatched longs would be measured as part of the net position, even though the company qualifies for the portfolio exception for the net position for interest rate risk.

Basis differences must also be considered. To the extent there is any basis difference for dissimilar risks, an adjustment should be made to the fair value of the net position. For example, a company may include financial instruments with different interest rate bases in one portfolio, as long as the company manages its interest rate risk on a net basis and there is high correlation among the different bases. An adjustment should be made to fair value to account for differences in how interest is driven. For example, an adjustment would be required to account for the difference between the London Interbank Offered Rate (LIBOR) and U.S. Treasury rates.

When using the portfolio exception where counterparty credit risk is managed on a net basis, companies should consider the expectations of market participants as to whether any risk-mitigating agreements in place are legally enforceable. For example, market participants may not expect that a master netting agreement designed to mitigate counterparty credit risk is legally enforceable in the event of default. In this situation, any adjustment for credit risk could be applied to the net exposure to the counterparty, rather than to each individual instrument.

For a net asset position, the adjustment should be applied to the net position, based on a particular counterparty's credit risk. For a net liability position, the adjustment should be applied to the net position, based on the company's own credit risk. The ASU does not affect the separate requirement to factor in a credit (or debit) valuation adjustment on a net open asset (or liability) position.

Unit of account. The ASU requires that the fair value of financial instruments be measured at the unit of account specified in the guidance for the specific financial asset, which can require valuation at the individual share level. Previously, financial assets that traded in homogeneous pools (baskets of financial instruments with similar characteristics) under an in-use valuation method might be grouped together when measuring fair value. Under the new ASU, firms can only do so if they can establish a portfolio exception.

The exception allows companies to measure the fair value of a financial asset based on the net position of the portfolio instead of the individual positions within the portfolio. The firm could value a group of securities on a portfolio basis with a blockage factor applied, if the exception were appropriately applied. The ASU assumes a company's ability to define the unit of account in other guidance, but doing so for loans and insurance products may prove challenging.

Conclusion

Given the challenges and opportunities it represents, all valuation firms should develop a comprehensive understanding of the new fair value ASU and meet with clients to explain its impact. With more than 300 pages of new changes in the ASU, learning the details of the ASU represents a challenge, but will be necessary in order to understand its impact on operations, processes, and valuation methods. Analyzing how the exception should be applied will increase the expertise of valuation firms seeking to do more business with larger financial institutions.

This rule represents the last round of convergence activities with the IASB. Interestingly there are still some differences, particularly relating to Level 3 sensitivity analyses and disclosures. As the convergence project between the FASB and the IASB proceeds, these remaining differences are expected to be ironed out, and valuation professionals can be certain that additional changes, and additional challenges, will be coming. ●