30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
E-mail: iasb@iasb.org Website: www.iasb.org

International Accounting Standards Board

This observer note is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. Views expressed in this document are identified by the staff as a basis for the discussion at the IFRIC meeting. This document does not represent an official position of the IFRIC. Decisions of the IFRIC are determined only after extensive deliberation and due process. IFRIC positions are set out in Interpretations.

Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: **September 2008, London**
Project: **Valuation of Restricted Securities (Agenda Paper 6B)**

---

1. The IFRIC has received a request to add an item to its agenda to provide guidance on whether a discount must be applied to the quoted market price when establishing the fair value of a security quoted in an active market when there is a contractual, governmental or other legally enforceable restriction that prevents the sale of the security for a specified period.

Submission

2. The submission notes that the restrictions could either be specific to the current holder of the security or transferable to the purchaser or transferee of the security. It states that diversity in practice exists only when the restriction is specific to the current holder and therefore limits its request for guidance to that situation. Examples include various participants in initial public offerings, such as underwriters or venture capital investors, who are prohibited from selling securities they hold or receive as part of the IPO for a specified period.

3. The submission identifies two views being applied in practice.

4. Under View A, no adjustment it made to the quoted market value of a security quoted in an active market regardless of the restriction that prevents the sale of the security. Proponents of View A believe that because the restricted shares are identical to the shares that are traded in an active market, IAS 39.AG71 prohibits the application of a discount. They note that IAS 39 IG E.2.2 prohibits an adjustment to the quoted market price when an entity holds a large block of shares of such a security.

5. Under View B, an adjustment is made to the quoted market value because although there is an active market, the entity does not have immediate access to it as a consequence of the restriction. Proponents of View B note that IAS 39.AG71 refers to the fair value of a security as the price in the most advantageous market to which the entity has immediate access. Consequently, proponents of View B believe that a discount should be applied to the quoted market price that represents the cost of using the forward market.

6. The submission also asks the IFRIC to provide guidance on whether the entity accepting the restriction should recognise deferred income in respect of the restriction. For example, if the entity received the shares in exchange for providing a service, should some of the market value recognised in accordance with View A be attributed to future services?

7. For more details, the full submission is included as Appendix A.

Staff Analysis

8. The staff notes that, as stated in the submission, IAS 39.AG71 provides explicit guidance on the measurement of the fair value of instruments traded in an active market, as follows:

> "The objective of determining fair value for a financial instrument that is traded in an active market is to arrive at the price at which a transaction would occur at the [measurement] date in that instrument … in the most advantageous active market to which the entity has immediate access. … The existence of published price quotations in an active market is the best evidence of fair value and when they exist they are used to measure the financial asset or liability."

9. In addition, the Board specified in AG72 that, "The fair value of a portfolio of financial instruments is the product of the number of units of the instrument and its quoted price." As the submission identifies, IG E.2.2 emphasises that no adjustment should be made to this result for a large holding of instruments.

10. The Board also addressed the issue of restrictions on the transfer of equity instruments in IFRS 2 *Share-Based Payment*. IFRS 2 includes the following requirements:

> "B2. For shares granted to employees, the fair value of the shares shall be measured at the market price of the entity's shares …, adjusted to take into account the terms and conditions upon which the shares were granted (except for vesting conditions that are excluded from the measurement of fair value in accordance with paragraphs 19 – 21).
>
> B3. For example, … if the shares are subject to restrictions on transfer after vesting date, that factor shall be taken into account, but only to the extent that the post-vesting restrictions affect the price that a knowledgeable, willing market participant would pay for that share. For example, if the shares are actively traded in a deep and liquid market, post-vesting transfer restrictions may have little, if any, effect on the price that a knowledgeable, willing market participant would pay for those shares."

11. Consequently, in IFRS 2 the Board concluded that a restriction on an employee's ability to transfer a vested share (that is, an inability to immediately access an active market) would be unlikely to affect the price that a market participant would be willing to pay for the share. In IFRS 2 the Board repeatedly emphasised that the objective of a fair value measurement is to determine what the market price of the share-based payment would be, not its perceived value to the holder of the instrument. In the staff's view, similar considerations apply to the issue identified in the submission.

12. The staff also notes that Examples 8 and 9 of the Implementation Guidance for SFAS 157 *Fair Value Measurements* discuss restrictions on the sale of a security or the use of an asset. The guidance distinguishes between restrictions that are specific to the security or asset and would therefore transfer to other

market participants and those that would not. When the restriction would transfer with the security, the quoted price for an otherwise identical unrestricted security of the same issuer that trades in a public market is adjusted to reflect the effect of the restriction. If the restriction is specific to the holder and would not transfer to other market participants, the market price is not adjusted.

13. The staff supports View A.

Staff recommendation

14. The staff recommends that the IFRIC not add this issue to its agenda. In the staff's view the issue is specifically addressed in the Application Guidance of both IAS 39 and IFRS 2 and the requirements of both standards are consistent. The market price of a security traded in an active market should not be adjusted for restrictions specific to the current holder. Consequently, the staff does not expect diversity in practice.

15. In addition, any guidance the IFRIC could add would relate to the implementation of the requirements of IAS 39.

16. Finally, the Board has a current project underway on Fair Value Measurement. If any additional guidance to that already provided in IAS 39 and IFRS 2 is necessary, it should be included in and be consistent with the conclusions the Board reaches in that project.

17. The staff does not believe that the IFRIC should attempt to provide guidance on the second question raised regarding the deferral of a portion of the value of the securities as income for the provision of future services. At previous meetings the IFRIC has noted the difficulty of determining whether the entity is required to provide any future service. The only issue the IFRIC might wish to clarify is that if no adjustment is made to the market price of the securities as a result of the restriction, the entity holding the securities cannot be providing any future services by accepting the restriction. However, in the staff's view this seems axiomatic and therefore unnecessary.

18. The staff has set out wording for the tentative agenda decision in Appendix B.

Question for the IFRIC

19. Does the IFRIC agree with the staff recommendation?

APPENDIX A

IFRIC POTENTIAL AGENDA ITEM REQUEST

The Issue

The issue is whether a discount must be applied to the quoted market price when establishing the fair value of a security quoted in an active market when there is a contractual, governmental, or other legally enforceable restriction that prevents the sale of the security for a certain period of time. Restrictions could either be specific to the current holder of the security or transferable to the purchaser or transferee of the security. We believe there are two views being applied in practice to the situation where the restriction is specific to the current holder. (We are not aware of significant diversity in practice in relation to the other situation).

One common example of this is when an underwriter or provider of other services to an entity in connection with an initial public offering of that entity is remunerated in the issuer's shares but, pursuant to the underwriting or other agreement with the issuer, is prohibited from selling the securities for a specified period. Another common example is where a venture capital investor retains a significant holding of securities following the initial public offering of an investee and accepts similar restrictions in respect of those securities.

The following are the two views being applied in practice:

View A

Under IAS 39.AG 71, a published price quotation in an active market is the best estimate of fair value. Therefore, in determining its fair value, no adjustment should be applied to the quoted market value of a security quoted in an active market regardless of whether there is a contractual, governmental, or other legally enforceable restriction that prevents the sale of the security for a certain period of time. Proponents of this view believe that because the shares are effectively the same shares that are traded in an active market IAS 39.AG 71 prohibits the application of a discount related to the restriction. Proponents of this view draw an analogy to IAS 39 IG E 2.2 which prohibits an entity from making adjustments to fair value when an entity holds a large block of shares in a security traded in the active market.

View B

IAS 39.AG 71 refers to fair value of a security quoted in an active market as being the price in "the most advantageous active market to which the entity has immediate access". In situations in which the holder of a security is subject to a restriction on its sale, the quoted market price for the security will be obtained from a market to which the holder has no immediate access. This could be due to the costs that would be borne by the entity if it were to breach the contract or other arrangement and sell the security in the restricted period. Alternatively, the entity may simply not have access to the market because it is legally prohibited form selling the shares. Consequently, proponents of this view argue that the holder should look to the (often hypothetical) forward market to ascertain the fair value of the security and, consequently, a discount should be applied to the quoted market price that represents the costs of using that forward market.

If the IFRIC conclude View A is the only possible answer under IFRS, we ask the IFRIC to consider whether an entity should also recognise deferred income in respect of the restriction on the shares. When an entity receives a security and at the same time accepts a restriction on its sale, it may be argued that the restriction has arisen because of the relationship between the entity and the issuer of the security. In other words, the entity has, in effect, agreed to provide future services to the issuer by not selling those shares for a certain period of time. In the first example set out above, the underwriter receives shares, with a restriction on sale, in lieu of underwriting services to be provided. It would seem appropriate that the underwriter, when recognising the shares in accordance with View A above, should defer a portion of the income for the period of the restriction to recognise the futures services to be provided.

In situations where there is no other relationship and no future services to be provided, this argument might be difficult to make. For example, some private equity houses accept a restriction on selling their shares following an IPO to ensure that there is an orderly market for the shares after the IPO. No other service or contractual relationship exists in this situation, thus it would be difficult to argue that income should be deferred.

Current practice:

We have seen both Views A and B applied in practice.

Reasons for the IFRIC to address the issue:

IFRIC should address the issue as there is diversity in practice and the guidance is not explicit with respect to this issue. Given that such discounts can be material amounts, financial ratios can be materially impacted by their recognition, as could comparability between entities. Although we appreciate that this issue may be addressed by the Fair Value Measurement project, we believe a more immediate solution is required.

APPENDIX B

The staff proposes the following wording for the tentative agenda decision.

IAS 39 — Valuation of Restricted Securities

The IFRIC received a request to provide guidance on whether a discount must be applied to the quoted market price when establishing the fair value of a security quoted in an active market when there is a contractual, governmental or other legally enforceable restriction that prevents the sale of the security for a specified period. Guidance was requested only in situations in which the restriction applied to the current holder of the security and would not transfer to another entity.

The IFRIC noted that the issue is specifically addressed in the Application Guidance of both IAS 39 and IFRS 2 and the requirements of both standards are consistent. The market price of a security traded in an active market should not be adjusted for restrictions specific to the current holder. Consequently, the IFRIC did not expect diversity in practice.

The IFRIC also noted that any guidance it could provide would be in the nature of implementation guidance rather than an interpretation. In its view any additional guidance that is necessary should be provided by the Board in its current *Fair Value Measurement* project.

The IFRIC therefore [decided] not to add this issue to its agenda.