30 Cannon Street, London EC4M 6XH, United Kingdom
Phone: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: http://www.iasb.org

International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting: **25 May 2006, London**

Project: **Fair Value Measurements (Agenda Paper 8E)**

Fair Value within the Bid-Ask Spread

SUMMARY

1 Often markets prices are quoted in terms of bid and asked prices. This paper examines existing guidance on bid-ask spreads in IFRS and US GAAP for the purpose of establishing a recommendation addressing the following questions:

(a) In circumstances when bid and ask prices are prevalent, what price represents the appropriate measure of fair value?

(b) Should a consistent pricing convention be used for offsetting positions?

2 In this paper the Staff concludes the principle in measuring inputs based on bid and asked prices and the guidance on accounting for offsetting positions in paragraph 32 of the draft FVM statement are appropriate (the first and third sentences of paragraph 32). However, the Staff does not agree with the FASB's decision to allow for the consistently applied pricing conventions as a practical expedient for fair value measurement (the second sentence of paragraph 32). The Staff recommends including a brief discussion in the invitation to comment

supporting the bid-ask principle and the guidance on offsetting positions, but articulating the view that using pricing conventions as a practical expedient to fair value would not be appropriate under IFRS, thus seeking comments from respondents on this matter.

BACKGROUND INFORMATION

3 Often markets prices are quoted in terms of bid and asked prices. Paragraph 11b. of the June 2004 FVM exposure draft provided a brief discussion of a circumstance where bid-ask spreads are commonly present:

> "In a dealer market, dealers stand ready to trade (either buy or sell for their own account), thereby providing liquidity by using their capital to hold an inventory of the items for which they make a market. Typically, bid and asked prices are more readily and regularly available than closing prices. In a dealer market, multiple identical exchange units are traded. "Over-the-counter" markets (where prices are publicly reported by the National Association of Securities Dealers Automated Quotations systems or by the National Quotation Bureau) are dealer markets. For example, the market for U.S. Treasury securities is a dealer market. Dealer markets also exist for other assets and liabilities, such as financial instruments, commodities, and physical assets (for example, certain used equipment)."

4 To clarify, this paper discusses bid and asked prices within the same market. This is not a discussion of prices in different markets.

DISCUSSION OF CURRENT IFRS GUIDANCE

5 Paragraph AG70 of IAS 39 states:

> "This Standard uses the terms 'bid price' and 'asking price' (sometimes referred to as 'current offer price') in the context of quoted market prices, and the term 'the bid-ask spread' to include only transaction costs. Other adjustments to arrive at fair value (eg for counterparty credit risk) are not included in the term 'bid-ask spread'."

6 Paragraph AG 72 continues:

> "The appropriate quoted market price for an asset held or liability to be issued is usually the current bid price and, for an asset to be acquired or liability held, the asking price. When an entity has assets and liabilities with offsetting market risks, it may use mid-market prices as a basis for establishing fair values for the offsetting risk positions and apply the bid or asking price to the net open position as appropriate."

7 The basis for conclusions of IAS 39 notes "applying mid-market prices to an individual instrument is not appropriate because it would result in entities recognising up-front gains or losses for the difference between the bid-ask price and the mid-market price." (IAS 39, paragraph BC99)

8 Paragraph E.2.1 of IAS 39 illustrates that deviation from the guidance in paragraph AG72 of IAS 39 is not appropriate even in circumstances where local regulations require the use of mid-market prices. E.2.1 states:

> "IAS 39.AG72 states that the current bid price is usually the appropriate price to be used in measuring the fair value of an asset held. The rules applicable to some investment funds require net asset values to be reported to investors on the basis of mid-market prices. In these circumstances, would it be appropriate for an investment fund to measure its assets on the basis of mid-market prices?
>
> No. The existence of regulations that require a different measurement for specific purposes does not justify a departure from the general requirement in IAS 39.AG72 to use the current bid price in the absence of a matching liability position. In its financial statements, an investment fund measures its assets at current bid prices. In reporting its net asset value to investors, an investment fund may wish to provide a reconciliation between the fair values recognised on its balance sheet and the prices used for the net asset value calculation."

9 The position in IAS 39 is consistent with conclusions elsewhere in IFRS. Specifically, IAS 36 and IAS 38 both state that the appropriate market price for an asset is usually the current bid price.

GUIDANCE IN THE DRAFT FVM STATEMENT

10 In developing the June 2004 Exposure Draft of the FVM statement the FASB considered existing US GAAP and SEC guidance, current practice, and guidance in IAS 39. The basis of conclusion of the June 2004 Exposure Draft refers to the SEC's Accounting Series Release No. 118 *Accounting for Investment Securities by Registered Investment Companies* (ASR 118). ASR 118 includes the following guidance:

> "If there was no sale on the valuation date but published closing bid and asked prices are available, the valuation in such circumstances should be within the range of these quoted prices. Some companies as a matter of general policy use the bid price, others use the mean of the bid and asked prices, and still others use a valuation within the range considered best to represent value in the circumstances; each of these policies is acceptable if consistently applied. Normally, it is not acceptable to use the asked price alone."

11 The basis of conclusion of the June 2004 Exposure Draft includes the following Discussion:

> "C49. Having clarified the fair value measurement objective and its exchange price notion, the Board considered whether to allow entities flexibility in applying that objective as currently permitted under ASR 118, specifying that the objective is to derive an exchange-equivalent price using bid and asked prices. The Board concluded that specifying the objective alone would not be sufficient. The methods used likely would continue to be different for different business activities (for example, market makers in securities). Instead, the Board decided to prescribe that method at the standards level to maximize consistency and comparability, focusing on Level 1 estimates (that is, bid and asked spreads created by firm offers to buy and sell in active dealer markets).

C50. Of the methods generally appropriate under ASR 118, the Board agreed that because a midpoint price averages multiple third-party dealer quotes, that method could derive an exchange-equivalent price, negotiated by reference to prices at either end of the spread. However, some constituents (broker-dealers) said that because dealers buy at or near the bid price and sell at or near the asked price, a midpoint price would result in an immediate (unrealized) gain and subsequent loss (similar to concerns about prohibiting the use of blockage factors in measuring blocks). They said that for dealers, industry practice is to use bid prices for long positions (assets) and asked prices for short positions (liabilities)."

12 In view of related concerns and existing practice, the FASB decided to adopt the approach in IAS 39 for the June 2004 Exposure Draft. However, the FASB decided bid-ask spread guidance should only apply to Level 1 of the hierarchy as other methods within the bid-asked spread should be considered for less active markets (similar to other Level 3 estimates). Paragraph 17 of the June 2004 Exposure Draft states:

> "In an active dealer market where bid and asked prices are more readily and regularly available than closing prices, fair value shall be estimated using bid prices for long positions (assets) and asked prices for short positions (liabilities). For offsetting positions, mid-market prices shall be used for the matched portion. Bid and asked prices shall be used for the net open position, as appropriate."

13 Respondents to the June 2004 Exposure Draft commented the conclusion would represent a change in practice for many entities given the existing guidance in ASR 118. Additionally, some respondents emphasized that for entities that enter into derivative instruments to manage risk, limiting that flexibility in measuring fair value within the bid-ask spread would create operational difficulties because many of those instruments are traded in active dealer markets and currently valued using other pricing methods (for example, mid-market prices or prices within a range of observable bid and asked prices).

14 In its redeliberations, the FASB reconsidered the required bid-asked spread pricing method and subsequently decided to emphasize the fair value measurement objective. The FASB decided to allow consistently applied pricing method within the bid-asked spread that represents the price at which market participants would currently transact. Further, the FASB concluded that bid-asked spread pricing methods appropriate under ASR 118 would be considered appropriate for the FVM statement as a practical expedient. Similarly, the use of bid prices for long positions (assets) and asked prices for short positions (liabilities) is also permitted but not required. Finally, the FASB decided to provide general guidance clarifying that for offsetting positions in the same instrument, the same price should be used to value both the long and short positions.

15 Respondents to the October working draft of the FVM statement commented bid-ask guidance should apply to all levels of the hierarchy, not just Level 1. Such respondents commented that Level 2 and Level 3 inputs are often quoted and developed on the basis of bid-ask spreads. The FASB agreed and subsequently decided to move the guidance on bid-ask spreads out of Level 1 to convey its application more broadly.

16 As a result, paragraph 32 of the current draft FVM statement includes the following guidance on bid-ask spreads:

> "If an input within the fair value hierarchy (Level 1, 2, or 3) is based on bid and asked prices (for example, in a dealer market), the fair value measurement shall represent the price within the bid-asked spread that would be received for the asset or paid to transfer the liability in a transaction between market participants at the measurement date. This Statement does not preclude the use of mid-market pricing or other pricing conventions, consistently applied, as a practical expedient for fair value measurements using bid and asked prices. For offsetting positions in the same instrument, the same price shall be used to measure the fair value of both the long and short positions."

STAFF ANALYSIS

17 The Staff asserts that the current guidance in IAS 39 and elsewhere in IFRS is rule based and seems to lack an underlying principle. Entities often transact somewhere between the bid and ask pricing points, particularly if the entity is a market maker or an influential investor. However, application of the rule in IAS 39 results in consistency across entities without consideration of entity specific factors that may influence where within the bid-ask spread the entity is likely to transact. Further, the rule creates a bright-line in quoted markets, thus limiting the use of judgement and subjectivity in the fair value measurement. [Sentence deleted]

18 In comparison, the first sentence of paragraph 32 states: "If an input within the fair value hierarchy (Level 1, 2, or 3) is based on bid and asked prices (for example, in a dealer market), the fair value measurement shall represent the price within the bid-asked spread that would be received for the asset or paid to transfer the liability in a transaction between market participants at the measurement date." Certainly, this sentence requires the use of considerable judgment in determining the fair value measurement. However, the sentence is clear, concise and entirely consistent with the underlying principles that form the foundation of the fair value measurement project.

19 The second sentence of paragraph 32 of the draft FVM statement allows for the use of a consistently applied pricing convention, such as mid-market pricing. While the guidance requires consistent application of any pricing convention, it allows significant flexibility without the need for an underlying reason to support using the pricing convention. The Staff is concerned about the consequences of a consistently applied pricing convention as a practical expedient to a fair value measurement in less liquid or highly volatile markets. The Staff asserts it is possible that bid ask spreads can be significant in less liquid or highly volatile markets. Use of a mid-market price convention in instances where the bid-ask spread is significant might result in the recognition of illusory gains or in the avoidance of losses or other than temporary impairments.

20 Regarding the guidance on offsetting positions, the third sentence in paragraph 32 of the draft FVM statement states the same price shall be used to measure the fair value of both the long and short positions. The Staff understands this to mean the same price should only be used for the offsetting position and that the net open position should be valued in accordance with the guidance in the first and second sentences of paragraph 32 of the draft FVM statement. The Staff observes this guidance is similar to the position in IAS 39, which allows the use of a mid-market price for an offsetting position. Paragraph BC 100 of the basis of conclusions to IAS 39 comments:

> "The Board believes that when an entity has offsetting risk positions, using the mid-market price is appropriate because the entity (a) has locked in its cash flows from the asset and liability and (b) potentially could sell the matched position without incurring the bid-ask spread."

21 The Staff agrees it is appropriate to use a pricing convention, such at mid-market pricing, for the offsetting position as a practical expedient. While the guidance in the third sentence of paragraph 32 is different from existing guidance in IAS 39, the Staff reasons the guidance in the draft FVM statement achieves the same objective. However, the Staff recommends the wording in the third sentence of paragraph 32 be clarified so that it is clear the same price should only be used for the offsetting position and that the net asset or liability position should be valued using the same policies the entity applies to other assets and liabilities with bid and asked prices.

Staff Recommendation

22 Based on this analysis, the Staff recommends adding a discussion to the invitation to comment that communicates agreement with the principle in the first and third sentences of paragraph 32 of the draft FVM statement. The Staff also recommends including a discussion in the invitation to comment communicating an alternate view regarding the second sentence in paragraph 32. The discussion would state it is not appropriate to use a consistently applied pricing convention as a practical expedient to fair value. While this recommendation would result in both a change to existing IFRS as well as a departure from the FASB's draft FVM statement, the Staff reasons this position

is more consistent with the fair value measurement objective than either the current IFRS position or the position in the draft FVM statement. An proposed draft of the discussion in the invitation to comment follows:

Question X – Market Inputs Quoted Based on Bid and Asked Prices

> The draft IFRS indicates that if a market input is based on bid and asked prices, the fair value measurement shall represent the price within the bid-asked spread that would be received for the asset or paid to transfer the liability in a transaction between market participants at the measurement date. The Board agrees with this principle. However, the draft IFRS also allows for the use of consistently applied pricing conventions (such as mid-market pricing or bid for assets and ask for liabilities). The Board reasons this practical expedient will reduce comparability of fair value measures. As such, the Board does not agree with this practical expedient.
>
> Do you agree with draft IFRS allowing use of a consistently applied pricing convention? Why or why not?

23 Finally, the Staff agrees with the FASB's conclusion that bid-ask guidance should apply to all levels of the hierarchy. It is the Staff's understanding that Level 3 inputs, particularly for structured financial instruments, are often developed in terms of bid and ask positions. As such, the Staff concludes the measurement objective for bid-ask pricing should be consistent in all levels of the hierarchy.

24 Does the Board agree with the Staff's recommendations and conclusions?