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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **October 2008, London**

Project: **Fair value measurement**

Subject: **Bid-ask Spreads (Agenda Paper 9)**

Introduction

1 At its June 2008 meeting, the Board reaffirmed its preliminary view as articulated in the *Fair Value Measurements* discussion paper that a fair value measurement should be determined using the price within the bid-ask spread that is most representative of fair value in the circumstances. This is consistent with paragraph 31 of FASB Statement of Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157). In reaching this view, the Board noted that different entities in different markets carry out transactions at different points within a bid-ask spread.

2 The Board did not reach a preliminary view on the following:

a whether it is appropriate to use mid-market pricing or another pricing convention as a practical expedient for fair value measurements within a bid-ask spread, even if the pricing convention is applied on a consistent basis.

b whether bid-ask guidance should apply only when bid and ask prices are observable in a market, or whether the concept should apply more broadly to fair value measurements in all levels of the fair value hierarchy.

This paper addresses these two issues.

Bid-ask spread guidance in SFAS 157 and IAS 39

SFAS 157

3 Paragraph 31 of SFAS 157 states:

> If an input used to measure fair value is based on bid and ask prices (for example, in a dealer market), the price within the bid-ask spread that is most representative of fair value in the circumstances shall be used to measure fair value, regardless of where in the fair value hierarchy the input falls (Level 1, 2, or 3). This Statement does not preclude the use of mid-market pricing or other pricing conventions as a practical expedient for fair value measurements within a bid-ask spread.

4 In its basis for conclusions SFAS 157 refers to the SEC's Accounting Series Release No. 118 *Accounting for Investment Securities by Registered Investment Companies* (ASR 118). ASR 118 states the following:

> 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. [Emphasis added.]

5 The FASB concluded that having clarified the fair value measurement objective in SFAS 157, entities should use judgement in meeting that objective. Accordingly, bid-ask spread pricing methods appropriate under ASR 118 are appropriate for SFAS 157. The FASB also concluded that the use of bid prices for long positions (assets) and ask prices for short positions (liabilities) is permitted but not required.

IAS 39

6 Paragraph AG72 of IAS 39 *Financial Instruments: Recognition and Measurement* states:

> 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. …

Comment letters

7 The *Fair Value Measurements* discussion paper asked the following questions with regard to bid-ask pricing guidance (ie pricing conventions and the hierarchy).

> Q22 Should a pricing convention (such as mid-market pricing or bid price for assets and ask price for liabilities) be allowed even when another price within the bid-ask spread might be more representative of fair value? Why or why not?

> Q23 Should bid-ask pricing guidance apply to all levels of the hierarchy, including when the fair value measurement includes unobservable inputs? Why or why not?

8 Respondents generally supported measuring fair value using the price within the bid-ask spread that is most representative of fair value in the circumstances. They indicated that such an approach achieves consistency with industry best practice and existing regulations for investment companies.

The use of a pricing convention

9 Many respondents disagreed with allowing a pricing convention (eg mid-market pricing or bid prices for assets and ask prices for liabilities) unless the difference in fair value is immaterial. They think that judgement could be misapplied in such situations, resulting in inconsistency in application and a loss of comparability across entities. Furthermore, they think a practical expedient does not belong in a principles-based standard.

10 However, some respondents were in favour of allowing a pricing convention. They think a pricing convention increases consistency and comparability amongst firms.

Furthermore, some think choosing ‘the most representative price’ is inconsistent with an exit price notion.

11 Furthermore, some respondents noted that they used mid-market prices prior to adopting IAS 39. IAS 39 discontinued this practice by requiring that assets be marked to bid prices and liabilities to ask prices. They are concerned that allowing a practical expedient will revert them to practice before IAS 39 (in other words, they do not want to have to keep changing).

Application within the fair value hierarchy

12 Many respondents think the bid-ask spread guidance should be applied in all levels of the hierarchy, although some wonder how it could be applied outside Level 1 (ie when there is not a quoted price in an active market for an identical asset or liability).

13 Those who support applying bid-ask spread guidance at all levels of the hierarchy note that there is a bid-ask spread for every asset and liability, regardless of how it is measured.

14 However, some respondents think that applying a bid-ask spread is not applicable (and might not be possible) in a hypothetical market or in a market that is very inactive. They are concerned that applying such guidance to Levels 2 or 3 of the hierarchy is subjective.

Staff analysis

15 The fair value measurement objective is to arrive at the price at which a transaction would take place in the instrument at the measurement date.

16 The Board’s decision in June to require entities to use the price within the bid-ask spread that is most representative of fair value in the circumstances is consistent with this objective. Requiring a pricing convention would not be. This section analyses whether a pricing convention should be allowed, and whether any bid-ask guidance should apply to all levels of the fair value hierarchy.

Allowing the use of a pricing convention

17 The staff acknowledges that the bid-ask pricing guidance in SFAS 157 might result in less consistency and comparability across entities and over time than if entities were required to use a current bid price for assets or a current ask price for liabilities. Clearly comparability is not likely to be a concern in an active market (ie in Level 1) as the spread would be relatively narrow. Thus, in an active market the ability to choose the most representative point within the bid-ask spread should not reduce comparability across entities.

18 However, in Levels 2 and 3 this might be an issue because spreads are typically wider (or not observable). The staff thinks the bid-ask pricing guidance in SFAS 157 does not reduce comparability across entities or over time as long as entities (a) are consistent in their approach to applying the bid-ask pricing guidance and (b) use the price at which they expect market participants in the same situation to transact, even if they do not all arrive at the same fair value. As noted by the Board in the *Fair Value Measurements* discussion paper, different entities in different markets carry out transactions at different points within a bid-ask spread.

19 In some jurisdictions investment funds are required to report to investors net asset values based on mid-market prices. If the Board allows a pricing convention as a practical expedient for fair value measurement, such investment funds would be able to report the net asset values based on mid-market prices as required. (Note that currently section E.2 of the Guidance on Implementing IAS 39 suggests that 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.)

20 Although the Board tentatively decided in June 2008 that a fair value measurement should be determined using the price within the bid-ask spread that is most representative of fair value in the circumstances, the staff thinks the Board should not preclude the use of mid-market pricing or other pricing conventions as a practical expedient for fair value measurements within a bid-ask spread when such a pricing convention meets the fair

Application within the fair value hierarchy

21 The staff thinks the fair value measurement objective applies at all levels of the fair value hierarchy. Thus, any bid-ask pricing guidance should not be restricted to situations in which there is an active market for the asset or liability.

22 It is the staff's understanding that, when pricing financial instruments, entities often model the instrument using mid-prices (for consistency across positions and for practical reasons), and then adjust the model price to reflect their position in the instrument (eg bid for long positions in assets or ask for short positions)—that is, they adjust the model price to reflect the price at which a market participant would sell the instrument. This practice is consistent with the fair value measurement objective and applies to all levels of the fair value hierarchy (Levels 1, 2 and 3).

Offsetting positions

23 The *Fair Value Measurements* discussion paper did not address the treatment of offsetting positions. However, prior to the publication of the discussion paper, the Board tentatively decided that the same price should be used for offsetting long and short positions in the same instrument (see Agenda Paper 8E for the May 2006 IASB meeting). This is consistent with IAS 39, which states in the basis for conclusions that:

> …for offsetting risk positions, entities could use mid-market prices to determine fair value, and hence may apply the bid or asking price to the net open position as appropriate. **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.** [IAS 39.BC100; emphasis added.]

24 SFAS 157 does not include guidance for offsetting positions. This seems to be because the bid-ask pricing guidance, as stated, would allow entities to determine, for each

position, the price within the bid-ask spread that would be most representative of fair value in the circumstances.

25 If the Board agrees with the staff's recommendations, the staff thinks it is not necessary for an exposure draft of an IFRS on fair value measurement to address offsetting positions.

Summary and staff recommendations

26 The staff recommends that an exposure draft of an IFRS on fair value measurement should:

- a state that it does not preclude the use of mid-market pricing or other pricing conventions as a practical expedient for fair value measurement within a bid-ask spread.
- b state that bid-ask pricing guidance applies to all levels of the fair value hierarchy (ie Levels 1, 2 and 3).

27 The staff thinks it is not necessary for an exposure draft of an IFRS on fair value measurement to address offsetting positions.

Questions for the Board

28 Do you agree that an exposure draft of an IFRS on fair value measurement should:

- **a state that is does not preclude the use of mid-market pricing or other pricing conventions as a practical expedient for fair value measurement within a bid-ask spread? If not, why not?**
- **b state that bid-ask pricing guidance applies to all levels of the fair value hierarchy (ie Levels 1, 2 and 3).**

29 Do you agree that it is not necessary for an exposure draft of an IFRS on fair value measurement to address offsetting positions?