Fair value and accounting standard for financial instrument

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Abstract. The measurement of assets and liabilities at fair value, with its subsequent gains or losses recognized in profit or loss, should be limited to financial investments that are readily convertible into cash or cash equivalents in active markets, and are not constrained by any business purpose. On the other hand, even though assets and liabilities are exposed to changes in the market price, those that are expected to obtain future funds and are constrained by some business purpose (non-financial investments) should not be measured at fair value through profit and loss. Under the Accounting Standard for Financial Instruments, fair value measurement is required in certain circumstances similar to IFRS or US GAAP. This paper describes how the fair value is used under the Standard and purposes to decide whether fair value measurement is required or not based on the type of investment.

Keywords: measurement, assets, liabilities, market prices.

1 Introduction

Under the Accounting Standard for Financial Instruments (IAS 39), fair value is defined as follows:

Fair value means the value fairly measured based on market prices actually transacted, or other quoted market prices, such as indicative prices or indices (hereinafter referred to as 'market prices'). If there are no observable market prices, rationally calculated values are used as the fair values.

Therefore, under the Accounting Standard for Financial Instruments, there are two types of fair value used to measure financial instruments: value based upon market prices and value rationally calculated. Furthermore, the Practical Guidelines of the Accounting Standard for Financial Instruments stipulates fair value in detail as follows:

If financial instruments are traded in an active market, and have a quoted price in the market, such instruments must, in principle, be measured at the fair value based on market price. Market prices are the amounts that are either obtained from the sale, or paid for the purchase of the financial instruments in the market.

2 The concept of fair value for financial instrument

For the following financial instruments, market prices are considered as being quoted in the market:

2.1. Financial instruments listed on exchanges

In principle, the market price of a financial instrument listed on an exchange is the price at which transactions take place on the exchange. If a financial instrument is listed on more than one exchange, the market price is the price available at the exchange, where it is traded most actively.

2.2. Financial instruments traded in over-the-counter transactions

The market prices of financial instruments that are traded in over-the-counter transactions are the prices quoted by business associations, which were established with the purpose of collecting information on over-the-counter markets, in order to provide information on fair prices. In cases where it is difficult to obtain the prices of financial instruments from such business associations, or the prices are not available at all, the prices at which brokers transact the financial instruments, including the indication prices for the financial instruments quoted by the brokers, may be recognized as the market prices.

For some listed financial instruments, the market prices used at exchanges are not fair values, either because the financial instruments were a very limited issue, or because the volume of trade in the financial instruments is too low. In such cases, the prices used in over-the-counter transactions are more appropriate to indicate fair value.

2.3. Financial instruments transacted, similar to (1) or (2) above, through systems that allow financial instruments to be sold, purchased, or converted readily into cash

When financial instruments are traded neither at exchanges, nor in over-the-counter transactions, but are sold, purchased, or converted readily into cash using transaction systems (including exchange markets between financial institutions, securities companies and dealers, and by electronic means), and there is a suitable environment to facilitate circulation of the financial instruments, the prices used in such systems may be regarded as market prices.

The market prices of financial instruments are to be obtained by the same method in every fiscal period. The method must not be changed, except for rational reasons, such as to improve the accuracy of the valuation.

When there is no quoted market price for financial instruments, but it is possible to calculate their value rationally, the rationally calculated value is used as the fair value. Financial instruments for which there is no market price are instruments other than those listed in (1) to (2) of the preceding section, and include the following:

1. financial instruments for which there is no quoted market price, or for which the price is only as agreed on between seller and purchaser for a particular sale;
2. financial instruments which are sold at exchanges or in over-the-counter transactions, but for which the number of transactions is extremely small, and which otherwise have no market price.

When there is no market price for financial instruments, or the market price is inadequate to be recognized as fair value, the fair value is the value rationally calculated by finance managers using any of the following methods:

1. the methods used to set market prices quoted by exchanges or over-the-counter market for similar financial instruments, making adjustment for variables, such as interest rates, maturity dates, and credit risks. In these cases, adjustments must be reasonable, without any element of subjectivity.
2. the methods used to calculate the current value of financial instruments by discounting future cash flows to be generated by the instruments. In these cases, other factors should be taken into consideration. The rate of discount must be reasonable, without any element of subjectivity.

Models adopted by the entity and volatilities that are reflected in calculations using models and factors used in determining prices, such as interest rates, must be decided reasonably, without any element of subjectivity.

When the entity encounters difficulty in estimating objectively the fair value of financial instruments, it may obtain a calculated value based on one of the above three methods by a broker, and may use that value as a rationally calculated value. It is also acceptable for the entity to use prices quoted by information vendors (companies that provide information related to investments, including financial indexes, market information, fair value information, and so on), who calculate market prices objectively, based on average prices from brokers or theoretical values.

Rationally calculated values for financial instruments are to be obtained by the same method in every fiscal period. The method must not be changed except for rational reasons, such as to improve the accuracy of the valuation.

The existence of markets makes it possible to obtain the fair value of financial assets that may be used as an objective value. It is also possible to convert financial assets into cash and to make settlements at fair value. The following reasons support requiring the fair value measurement of financial assets:

Measurement at fair value of the financial assets of the entity is to be implemented so as to present in financial statements the actual status of the financial activities of entity, and to provide appropriate financial information to investors. Such information would help investors make their own decisions on investments under the current circumstances in which financial assets are held, the risk of price volatility is increasing, and financial transactions are made internationally.

Accounting is to reflect the actual status of financial asset transactions. Such accounting is useful for the entity itself to obtain a sufficient understanding of the details of transactions, to conduct thorough risk management, and to evaluate the results of financial activities precisely.

Merely providing fair value information in the notes to financial statements would not be a sufficient disclosure of fair value information on financial assets. Financial assets that can be converted into cash or settled (except for financial assets for which an objective fair value is unobtainable) are to be measured at fair value, and the fair value is to be reflected appropriately in financial statements.

However, given the characteristics of the financial assets and the entity's purpose for holding them, there may be financial assets which are substantively free from risk on change in the market price, or where disposals or conversion into cash are constrained by business objectives. We believe that measurement at fair value, without taking into consideration the purpose for holding financial assets, would not adequately reflect the financial situation and operating results of an entity in its financial statements. Therefore, in our view, while establishing measurement at fair value as a basic principle, it is appropriate to apply different accounting treatments to financial assets depending upon the purpose for holding them.

On the other hand, there may well be no active market for financial liabilities such as loans payable. Even in the case of financial liabilities for which markets do exist, such as corporate debt securities, business activities restrict entities from settling their own debt securities at fair value. Accordingly, it is appropriate to measure financial liabilities (except for net payables resulting from derivatives) at face value, not fair value. However, when the face value differs from the amount received (e.g. corporate debt securities issued at a discount or premium), the amortized cost is to be used in balance sheets.

Based upon the discussion of profit information in the preceding section, if financial instruments are categorized as non-financial investments (operating investments), past changes in fair value are meaningless for users of financial statements in making predictions of future income or cash flow, and in confirming or correcting their past expectations. This is because such investment is carried out irrespective of the past changes in fair values of the individual financial instrument.

3 Conclusions

In conclusion, some of the reasons why the boards believe that fair value is the most relevant measurement attributed for financial instruments are presented as follows:

1. Fair value incorporates the current market assessment of the future, including the amount, timing, and uncertainty of future cash flows attributable to a financial instrument. Fair value information

provides a benchmark measurement that users of financial statements may adjust to reflect their own expectations. Fair value information permits financial statement users to make decisions based on information about current conditions, rather than on information about conditions that existed at the time an entity purchased a financial asset or incurred a financial liability.

2. As a concept, fair value reflects the collective assumptions and expectations of market participants, rather than entity-specific assumptions and expectations. Fair value information facilitates period-to-period comparisons for a single entity as well as comparisons between different entities.
3. Changes in fair values reflect the effects of changes in market conditions when they occur. Therefore, they reflect the effects of management decisions to buy, sell, incur, extinguish or hold financial assets or financial liabilities on a timely basis.
4. Volatility in reported financial performance arising from changes in fair values of financial instruments reflects market volatility. The boards believe that reporting the volatility arising from changes in fair values of financial instruments provides information that helps users of financial statements in making their predictions of future income expectations and potential variability of future returns, and in confirming or correcting their past expectations.

4 References

IASB's *Web page*: Retrieve from <http://www.iasb.org/_uploaded_files/documents/16_99JFinancial-Instruments-long-terrnobjectives.pdf>.

Discussion papers are available from ASBJ's homepage: <http://www.asb.or.jp/e_asbj/ begrifl7ConceptualFramework.pdf>.

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