The Critical Aspect on Using Fair Value for Financial Instruments

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Abstract. The variety of the book-keeping practices, of the financial auditor, of the fiscal norms and rules, can have a negative impact, not only on the companies' ability in furnishing the needed and true financial information to the creditors and investors, but also on the capacity to analyze the future investment opportunities regarding the financial instruments, which are vital for the economic increment. Under the Accounting Standard for Financial Instruments, fair value measurement is required in certain circumstances similar to IFRS or US GAAP. There are also specialists who criticize the limited use of fair values in IFRS. However, those criticizing fair value accounting do not seem to provide any credible alternatives. Do we go back to historical cost accounting, wherein the financial assets are stated at outdated values and hence are not relevant or reliable? In the current crisis, a question that is raised is: Should financial instruments be marked down to their current throw away prices? 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, fair value, convergence, financial instruments.

Jel Classification: D46, G01, O16

1 Introduction

The most incomplete component of the existing frameworks of the IASB and FASB is measurement. The frameworks merely provide a list of the existing measurement attributes, one of which, present value, is actually measurement technique rather than a measurement attribute. No attempt is made to evaluate the identified measurement bases. Not surprisingly then, one of the major phases of the conceptual framework project currently being progressed by the IASB and FASB is the measurement phase. This will involve identification of possible measurement bases and evaluation of those bases by reference to higher order concepts in the framework, namely the objective of financial reporting and the qualitative characteristics of decision-useful information.

In the Roadmap for Convergence between IFRS and US GAAP the IASB and the FASB established explicit long-term objectives for improving financial reporting for financial instruments, to help the boards evaluate and prioritize future projects on financial instruments. In addition, the boards agreed to work towards those long-term objectives while retaining the ability to work either jointly or separately (if necessary) on shorter term objectives that are consistent with the long-term objectives.

These long-term objectives for simplifying and improving the accounting for financial instruments – assuming that technical and practical hurdles can be overcome - are to:

1. Require that all financial instruments be measured at fair value with realized and unrealized gains and losses recognized in the period in which they occur;

2. Simplify or eliminate the need for special hedge accounting requirements;

3. Develop a new standard for de-recognition of financial instruments.

It seems that establishing a long-term objective sends a signal to any other interested parties that the two boards are committed to improving and simplifying financial reporting. In particular, the first long-term objectives are to require full fair value. However, we have concerns about the above long-term convergence objective because:

1. The types of investments in the financial instruments are not simple. Accordingly, simplifying by full fair value would not satisfy representational faithfulness. Rather, such simplification would prioritize form (as financial instruments) over substance, and thus would not improve the financial reporting.

2. Simplification or improvement could not be achieved, even if all financial instruments were to be reported at their fair values, as long as the non-financial instruments are accounted for by mixed-attribute. The reason why most non-financial instruments such as inventories and properties are reported on a cost basis should be debated. We believe that the use of mixed-attribute measurements determined by the type of investment, including financial instruments, is more appropriate that fair value for financial instruments.

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.

Although the information on future cash flows is used in various ways, including assessing the probability of solvency, estimating the value of an entity is one of the key aspects for users, in particular when investors decide whether to buy, sell, or hold their investments in stocks or bonds. We believe that when investors use information on future cash flows to estimate the value of an entity, profit information is important. In other words, historical profit, which is the performance of investments, is more useful than historical cash flows in predicting future cash flows (including future profit and future dividend) under the accrual accounting system.

The measurement of financial instruments at fair value, with 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 that 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.

2 The concept of fair value for financial instrument

The accountancy of the XXIst century requests a unique value. A solution for the amelioration of the accountancy information could be, after some of the specialist, the real value. This instrument was introduced by the accountancy-shapers as answer to degradation of the confidence into the financial measurements and regards a new system of evaluation for the assets and the debts of the entity.

Using the existing definition of fair value in IFRS literature, fair value represents the amount for which an asset or liability could be exchanged in a current transaction. That amount compounds the expectations of market participants regarding the future net cash inflows to be generated by an asset or the future net cash outflows to be sacrificed in settling or extinguishing a liability.

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

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. 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.

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.

According to the FASB project of financial instruments, the second long-term objective is to simplify the requirements for hedge accounting and, if possible, to reduce or eliminate the need for special accounting for fair value hedges.

The fair value option in IAS 39 substantially reduces the need for special accounting of fair value hedges of financial instruments. Thus, it permits entities to avoid the related burden of designating hedging relationships, and tracking and analyzing hedge effectiveness.

However, as the project also mentioned, special hedge accounting rules would still be required in the following cases even if all financial instruments were measured at fair value:

1. Situations in which the hedged item is not a financial instrument and is not measured at fair value under existing accounting requirements (e.g. a commodity);

2. Some hedges of future cash flows (such as hedging the risk arising from forecast future sales denominated in a foreign currency or hedging a variable interest rate financial instrument when changes in rates do not change the fair value of the financial instrument).

In the same time, thus hedging fair value exposure would conceptually be an exceptional treatment; rather, hedging cash flow exposure would be a core concept of hedging that is consistent with the recognition and measurement method for non-financial (operating) investments.

But the problem apparel when hedging the exposure to variability in future cash flows (e.g. debt with variable interest covered by fixed interest swap), the deferral method is necessary to achieve the objectives of financial reporting. In this case, the fair value of the existing asset or liability having the cash flow exposure (e.g. debt with variable interest, a forecasted transaction) will not change significantly, and therefore, deferral of the gain or loss on the hedging instrument is the only way to account for the hedge relationship. This shows that deferral hedge accounting' is a primary method because the mark-to-fair-value method cannot substitute for it.

If the hedged items are ones that are measured or are to be measured at fair value because variability in those future fair values is exposed, hedge accounting is not or will not be necessary. Therefore, hedge accounting for hedging the exposure by a derivative is limited to the hedged items that are not to be measured at fair value (e.g. in cases where loans to originated customers with fixed interest (non-financial (operating investment) are economically converted to loans with a floating interest

rate by entering into an interest rate swap). Even in such cases, the deferral method may also be applied.

So, hedging that had the effect of combining the hedging instruments and the hedged items would be deemed to be a non-financial (operating) investment because the hedged items were originally non-financial (operating) investment, as mentioned above.

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

IAS 39 currently contains an option that permits entities to measure most financial assets and liabilities at fair value with changes in fair value being recognized immediately in profit or loss. The consequences include lack of reliability due to

absence of quoted prices in active markets, increased volatility of reported profit creating potential for misunderstanding by investors and irresponsible lending practices resulting from the recognition of unrealized gains.

Of course it is unrealistic to expect the Board to require all financial instruments to be measured at fair value as result of a fundamental review of IAS 39, even if a substantial majority of the Board believes that ultimately fair value should be the required measurement attribute for all financial instruments. However, it is reasonable to expect the Board to give serious consideration to requiring greater use of fair value than the existing Standard. A likely candidate is measurement of financial assets.

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.

Even if fair value is the most relevant measurement attribute for all financial instruments for balance sheet presentation purposes, changes in the fair value of financial instruments should not necessarily be recognized directly in net income. Similar to the treatment of available-for-sale securities, a combined approach where

fair value is presented in the balance sheet but not included in net income should be applied to some financial instruments that have subjective goodwill.

On top of that if all financial instruments were measured at fair value with changes reported in earnings, the concept of hedge accounting for hedging cash flow exposure would still be indispensable. This is because non-financial instruments were not always measured at fair value.

Fair value is here to stay. It is already deeply embedded in IASB and FASB literature and there are growing calls from the user community to increase its use in financial reporting. Conceptual support for fair value is demonstrable and will be further underpinned in the revised conceptual framework. Users, preparers, auditors and regulators will become more comfortable with the use of fair value as time passes. Concerns about the 'lack of reliability' of fair value estimates and about the reactions of market participants to 'increased volatility' of reported profit will diminish as markets develop, as valuation methodologies improve and as the financial reporting community becomes more experienced in its use of fair value. Those who criticize the limited use of fair values in IFRS should question their application of national GAAP and whether previous financial statements really had the qualities they claimed.

Moving from theory to practice, the question perhaps becomes: What are the informational advantages and disadvantages of the practicable proxies to fair value, value, both when applied consistently, and when applied pragmatically on an item-by item basis? This takes us back to the academically traditional debates on the pros and cons of the various theories of income measurement and asset valuation. Many academics have strongly held view on these issues.

The conclusions refer to possible areas in which the IASB might provide further clarifications and guidance or extend the use of fair values. Moreover, as all interested parties gain experience in the use of fair values for financial instruments, the aforementioned concerns will dissipate.

4 References

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

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