Tentative translation

Practical Issue Task Force No. 25

Practical Solution on Measurement of Fair Value for Financial Assets

October 28, 2008

The Accounting Standards Board of Japan

Objectives

Accounting for financial instruments and measurement of fair value are conducted based on the Accounting Standard for Financial Instruments (ASBJ Statement No. 10) and Practical Guidance on Accounting for Financial Instruments (JICPA Guidance No. 14) and related rules.

Accounting for financial instruments and measurement of fair value which the above Statement and Guidance stipulate, are considered to be based on the same approach as the treatment in the international accounting standards. In this regard, we have received questions on measurement of fair value, with relation to the publication issued by international accounting standard setters in the background of recent turmoil in financial markets. Measurement of fair value of financial assets is conducted according to the Statement No. 10 and JICPA Guidance No. 14 and related rules, and we hereby confirm the current treatments which had invited many questions in order to enhance better understanding of those standard, guidance and rules.

Accounting Treatments

Q1: What is the notion of the fair value?

A: Fair value refers to “the fairly measured value based on transaction prices formed in a market or other quoted market prices such as indicative prices or indices (hereinafter referred to as “market prices”). If market prices are not available, rationally calculated values shall be used as the fair values” (Paragraph 6 of the Statement No. 10).

In this case, the fair value is “the value which would be expected to be used in a voluntary transaction between independent third parties who have sufficient knowledge of the business” (paragraph 47 of JICPA Guidance No. 14). Followings are the basis of the notion of the fair value:

“1) Parties to a transaction of the financial assets must understand the details, structure, mechanisms and, in particular, the typical risk and return characteristics, of the financial assets.

2) Parties to a transaction of financial assets, on a going concerns basis, must trade using their own judgment in the pursuit of their own economic advantage, and must not conduct

transactions under compulsion or under disadvantageous conditions.

3) The fair values of financial assets are the cash flows receivable or payable when parties to transactions acquire, sell, enter into agreements on, or make settlements on, the financial assets.
4) In principle, the fair value of financial assets is their market price. For financial assets that are actively transacted in a market with sound liquidity, the prices in the market are the best basis for fair value. However, the market price of financial assets is sometimes not the fair value if, for example, the market is not active, or is not well established and organized. In such cases, or in cases where it is impossible to ascertain market prices, or there are no market prices, the rationally calculated value, that meets the requirements presented in this Guidance, is considered to be the fair value." (Paragraph 256 of JICPA Guidance)

It should therefore be noted that prices formed in transactions forced to accept compulsory or disadvantageous conditions do not represent a fair value.

Q2: Is a market price required to be used as a fair value if there is a market price?

A: If financial assets are transacted in a market[1] and have a price in the market, the fair value of such financial assets must, in principle, be the value based on market prices, which is generally regarded as a fair value (regarding this point, refer to paragraph 48 of JICPA Guidance No. 14). This is because a price formed in a market where a financial asset is actively traded is generally considered indicating a fair value of that financial asset.

However, a financial asset is considered having no market price (or the market price cannot be recognized as a fair value) where "Financial assets which are traded in exchanges or in over-the-counter transactions but for which the number of transactions is extremely small" (Paragraph 53(2) of JICPA Guidance No. 14), or where there is a significantly large spread between the amount sellers are asking and the amount buyers are bidding. In such circumstances, "the fair value is the rationally calculated value based on the management's rational estimation" (Paragraph 54 of JICPA Guidance No. 14).[2]

As mentioned in the answer to the question 1 above, it is one of the premises to calculate the fair value of a financial asset that parties to a transaction of the financial asset must understand characteristics of the financial asset. In addition, "company's management, as one of parties in

1 Markets include public exchanges and other similar exchanges and transaction systems that allow purchases, sales, and liquidation, to occur on demand. (Note 2 and Paragraph 54 of ASBJ Statement No. 10)

2 In regard to stocks, "only those stocks which have a value based on market price, and which are traded on a market, are regarded as having a fair value. Therefore, stocks which are not traded on a market are regarded as securities for which no fair value is obtainable (no rationally calculated value), even though it may be possible by some methodology to calculate the value of such stocks." (Paragraph 63 of JICPA Guidance No. 14)

a transaction, is expected to calculate the rational amount to constitute a fair value." On those premises, "when no market price is available, the fair value is calculated, generally by rational estimation of company's management" (Paragraph 259 of JICPA Guidance No. 14).

Q3: Is there anything that the management needs to be aware of when a fair value is calculated based on the management's rational estimation because there is no market price or a market price cannot be recognized as a fair value?

A: The rationally calculated amount based on the management's rational estimation is a price calculated using one of following methods:

"(1) The methods used to set market prices published by exchanges etc. for similar financial assets, making adjustment for variables such as interest rates, maturity dates and credit risks, etc.
In these cases, adjustments must be rationale, without any element of subjectivity.

(2) The methods used to calculate the present value of financial assets by discounting future cash flows to be generated by the assets.
In these cases, other variables should be allowed for. The rate of discount must be rational, without any element of subjectivity.

(3) The methods used in generally accepted theoretical value models or pricing models (including option-pricing models such as the Black-Scholes formula and the binomial model).
Models adopted by companies, volatilities which are reflected in calculations using models, and variables used in determining prices, such as interest rates, must all be rational, without any element of subjectivity." (Paragraph 54 of JICPA Guidance No. 14)

"When a company encounters difficulty in objectively estimating the fair value of financial assets, it may request a broker to give a value calculated by the broker by one of the above three methods, and may use that value as a rationally calculated value" (Paragraph 54 of JICPA Guidance No. 14). It should, however, be noted that "the brokers must be reliable, objective and independent from the companies" (Paragraph 259 of JICPA Guidance No. 14).

Effective Date

This Practical Issue Task Force ("PITF") is purposed to confirm practical solution of specific issues based on accounting standards currently in effect. Therefore, this PITF is applied to any financial statements, which have not yet been published when this PITF is released, even if the accounting year (including quarterly or semi-annual period) of the financial statements has already been ended. It should be noted that the application of this PITF is not treated as a change in accounting policy.

If disclosure as to application of this PITF is considered to contribute to the user's better understanding of the financial statements, its outline should be disclosed in the notes to the financial statements.

Voting

This PITF was approved by all 12 board members who attended the ASBJ 163th board meeting.

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