Realized income and changes in market price of financial assets

Abstract

The income measured in accounting (net income or earnings) is not the economic income mentioned above. Instead, measure of income captures the extent to which the results expected at the time of the investment have been achieved (i.e., realized). In other words, the performance of an investment is measured based on the ex post facts that can be compared with the ex ante expectation. Since an investment is made in expectation of cash flows, it is natural that the ex post fact to be compared with the expectation is the actual cash flows. The realized income for accounting purposes is measurement of performance based on the fact of cash flows, adjusted by allocation on the accrual basis. This concept implies that performance of an investment is not measured by changes in the value of

assets held, but measured based on the realization of cash flows that were expected or not expected before the fact. In cases of real investments in business operations, income is measured in terms of cash flows arising from business activities such as sales of products, regardless of changes in the value of

operating assets. Conventional accounting standards (so-called historical cost accounting) that avoid value assessment of assets and instead allocate the cost among periods is inextricably linked with such concept of realized income. On the other hand, in cases of investment in financial assets, in general, cash flows as results of the investment are realized without waiting for sales. Changes in the value (equal to market value) of financial assets, unlike cases of physical assets, themselves have the same meaning with realization of cash flows. As already mentioned, future cash flows expected to arise from financial assets can be changed into the present cash flows at any time and at a market price that is equivalent to the future cash flows. When this price is same to anyone, a change in the market price of financial assets is already an achieved result of investment and therefore can be considered as realized income, even if it is not yet converted into cash through sales. However, conventional accounting standards and practices have generally considered a sales transaction as the requisite for realization of the results, in cases of financial investments as well as in cases of real investments. That is, while inflows and outflows of financial assets are included in cash flows as a requisite for realization, changes in their market prices are not. For example, when goods are sold in exchange for some financial assets, the income on the real investment is considered as realized even if it is not cash sales. On the other hand, when the market price of a financial asset has increased, the result has not been deemed as realized until it is converted into cash. We can say that judgment about whether financial assets

are identical to cash has been made differently between in cases of real investments and in cases of financial investments. This is not a matter of the realization basis itself but rather a matter of its interpretation. Such an interpretation about realization of income has been a significant obstacle to recognition of valuation gains or losses of financial assets not bound to business activities. It appears that the FASB

intended to become free from such restriction when it adopted the new criteria of "realizable" instead of "realized"5). However, physical assets used in business also sometimes have markets where they can be converted into cash and therefore they are often "realizable" in that meaning.Unless fair value measurement of physical assets is intended, it would have been enough to make the concept of realization separated from sales transactions and refine it in line with a broader sense of cash flows Anyway, with regards to financial assets that can be sold freely, there is no difference between the change in market price during the holding period and the change in stock through a sale. In this meaning, changes in the market price of financial assets are the same as realization of cash flows. If such a case is required to be backed up with an actual sale, it is a requirement alien to the role of realized income whose aim is to affirm the ex ante expectation by the ex post facts. Considering in this way, valuation gains or losses on financial assets would be, in principle, included in

the realized income that excludes valuation gains or losses on physical operating assets.

Conclusion

As the discussion above shows, measurement of realized income, which is a traditional business in corporate accounting, does not necessarily preclude valuing financial assets at fair value and recognizing the resultant gains or loss in income statement. If anything, under the concept of economic income, changes in the value should be recognized for not only financial assets but also physical operating assets. If the appreciation concept is adopted, changes in market value cannot be neglected even when goodwill can be neglected. If such revaluation of physical assets is not considered at present, we should give more attention to the concept of realized income and discuss about it in depth. As mentioned below, the largest issue from such viewpoint would be mark-to-market measurement of financial assets that are bound to business activities and therefore cannot be freely sold.

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