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THE THEORETICAL BASE OF FINANCIAL INSTRUMENTS

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Abstract. In this article are given main notion about international standard of financial instruments and tries to explain theory using transaction cost financial method. Specifically how specificity which is one of the three most important attributes for characterizing theoretical base, can effect financial investment, investor choice and investment fees in a setting when customers/suppliers as stockholders of the firm are included. Therefore, article is exploiting on improvement of theoretical basis of financial instrument with the purposes of private and small business development. According to the aim and logic of article the following tasks are formulated specifically study of foreign experience of investment on the basis of the foreign and domestic scientists and mass media, international standards: what is convergence and whether there is any like hood of convergence between Central Asian and European financial organizations and exploiting recommendation on introduction of foreign experience in the investment market of Uzbekistan on the basis of analysis of experience developed countries.

Keywords: investment, stock, bonds, inflation-indexed bonds, futures, options, swaps, financial instruments, IASC, IFRS.

Jel classification: D53, M40, P33

1. Introduction

One of the most important investment decisions that an investor encounters is the allocation of funds among the wide range of financial instruments. As is acknowledged in recent literature, the financial instrument plays a crucial role in economic development. The Common-stock market spans the length and breadth of the financial spectrum, from a new start-up company to a mature conglomerate, from a "mom and pop" shop to an international giant, from a domestic corporation to a foreign company. All want to do the same thing-get the public to investing them. This is a way for a company to raise capital. It is literally selling shares of itself to the public (David 2009). That decision requires an understanding of the investment characteristics of all asset classes. The market of financial instruments, also called securities market, is a constituent part of economy, which allows re-distribution of financial resources between separate economic entities. As a result, the companies can accumulate necessary financial resources, whereas households and other economic entities have a possibility to invest and expect a return on investment.

Information acquisition costs create incentives for financial intermediaries to emerge (Diamond 1984. The ability to acquire and process information may have important growth implications. Because many firms and entrepreneurs will solicit capital, financial intermediaries and markets that are better at selecting the most promising firms and managers will induce a more efficient allocation of capital and faster growth. The behaviour of financial markets makes it possible to understand the general economic status of a country: the rising share prices show positive investor expectations and possible economic growth and vice versa - the falling share prices mark poor activity or prospects for a company or the whole national economy. Economic processes, which are related to the market of financial instruments, not only influence trade inside the country, but also attract foreign and institutional investors, whose capital contributes much to the creation of economic welfare, and increases the liquidity and global competitiveness of the market of financial instruments.

2. Financial instruments: classification and evaluation

The term financial instrument has a variety of definitions. According to Dubil financial instruments are classified into: fixed income securities, equities, derivatives: futures, swaps, options, exchange-traded funds, ect. Other side classifies financial instruments into securities (shares), derivatives, and short-term and long-term Debt securities (Fabozzi, Peterson 2003).

Financial Instruments can be classified by the type of claim that the holder has on the issuer. When the claim is for a fixed dollar amount, the financial instrument is said to be a debt instrument. In contrast to a debt obligation, an equity instrument obligates the issuer of the financial instrument to pay the holder an amount based on earnings, if any, after the holders of debt instruments have been paid. Common stock is an example of an equity claim. Financial instruments make a major part of actives and obligations of many organizations, in particular the credit organizations. Financial instruments play the leading part in maintenance of effective function the financial markets. Last three decades the market of financial instruments significantly has grown both quantitatively, and is qualitative; its progress was accompanied by occurrence all of new and new types of financial instruments, including derivative tools. In modern conditions banks and the companies are not limited to use of traditional primary tools, resorting to complex tools of management of risks where are actively applied and the interconnected financial instruments. Financial instrument - means any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument - from another company. Some securities fall into both categories in terms of their attributes. Preferred stock, for example, is an equity instrument that entitles the investor to receive a fixed amount. This payment is contingent, however, and due only after payments to debt instrument holders are&made. Another "combination" instrument is a convertible bond, which allows the investor to convert debt into equity under certain circumstances. Both debt instruments and preferred stock that pay fixed dollar amounts are called fixed-income instruments.

As will become appavent, there are a good number of debt instrument available to investors. Debt instruments include loans, money market instruments, bonds, mortgage-backed securities, and asset-backet securities (Fig. 1). In the chapters that follow, each will be described. There are features of debt instruments that are common to alla debt instruments and they are described below. In later chapters, there will be a further discussion of these features as they pertain to debt instruments ofparticulsuers.

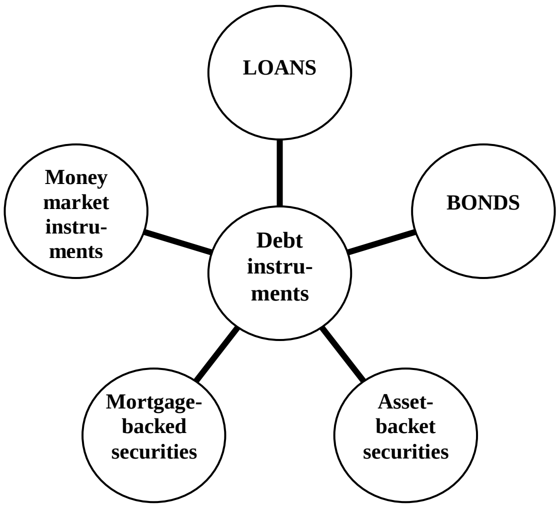

Fig.1. Debt instruments (Source: Farbozzi, 2002)

The abbreviated definition provided in the Republic of Lithuania Law on Markets in Financial Instruments: A financial instrument means any of the following instruments: transferable securities, money market instruments, securities of collective investment undertakings, options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities, currencies, interest rates or yields, or other derivatives instruments, financial indices or options, futures, swaps, forward rate agreements and any other derivative contracts relating to commodities, and financial contracts for differences. Only equities have been preserved as the "original" financial instruments in the present day Lithuanian financial market, whereas debt financial instruments often have the features of derivatives (e.g. Lithuanian bank bonds are linked with the raw materials price index). The CFI (classification of financial instruments) code based on ISO-10962 (2001) standard defines the nature of financial instruments most precisely. Thus the following breakdown of the financial instruments based on that standard is used:

E – Equities;
D – Debt instruments;
R – Entitlements or rights;
O – Options;
F – Futures;
M – Others or Miscellaneous.

Although different terminology is used, the financial instruments are classified into three main groups: equities, debt instruments and derive tives (Fig. 2).

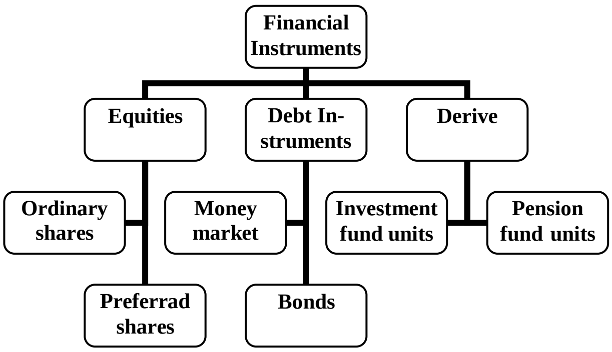

Fig. 2. The groups of financial instruments currently used in Lithuania (Source: created by authors, information used from Republic of Lithuania Law on Markets in Financial Instruments)

The financial intermediaries licensed in Lithuania can offer from the range mentioned above all financial instruments traded on and off the regulated Lithuanian market and can act as intermediaries almost in all financial markets of the world.

3. Money market

The development and regulation of stock markets play a key role in the financial system architecture in transition economies (Hermes, Lensink, 2000).

There were no stock markets in Central Asia during the 40−70 years of socialism. Nowdays, the fast expansion of stock markets is seen as an important component of the development of the financial sector in these economies. Stock market development and other aspects of financial market development take place simultaneously and complement each other. A crucial question, however, is to what extent and under which conditions stock market development may contribute to a process of long-term economic growth. For example, Levine and Zervos strongly suggest that stock markets contribute positively to economic growth (Levine, Zervos 1998a). Moreover, they do not find any evidence of a negative effect of stock price volatility or capital market integration on economic growth. However, there are others who argue that stock markets do not play an important role since only a small part of corporate investment is financed by means of equity. Stephen G.Ryan (2007) is a well-known opponent of the view that stock markets are crucial for long-term economic growth.

Things were slightly better in Uzbekistan with the formation of the Market Infrastructure. According the Publication of the Centre of Coordination and Control of Securities Market and State Property Management of Uzbekistan at the moment the following have been developed and modernized (Fig. 3).

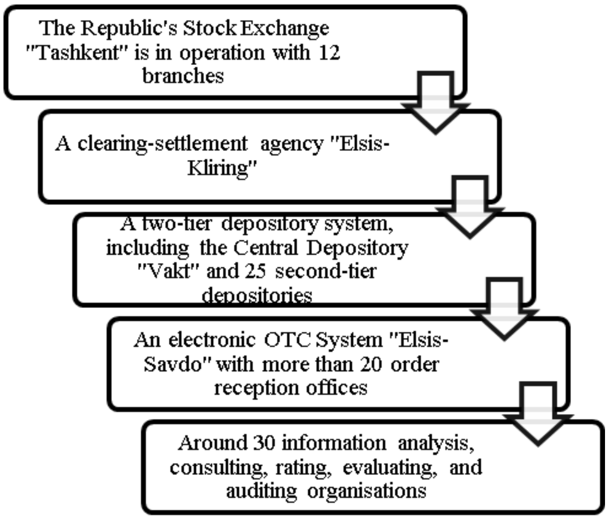

Fig. 3. Controller of Securities Market in Uzbekistan (Source: The publication of the Centre of Coordination and Control of Securities Market and State Property Management of Uzbekistan 2009)

Fair value accounting for financial instruments is increasingly feasible for two reasons:

1. The markets for financial instruments have become much richer over time. For example, risky assets that previously were difficult to trade, such as commercial loans, how can be securitized.
2. Financial theory, such as options pricing, has developed and been applied successfully in many contexts by practitioners (Ryan 2007).

Money market instrument meets short term requirements of the borrowers and provides liquidity to the lenders. Common Money Market Instruments are as follows (Fig. 4).

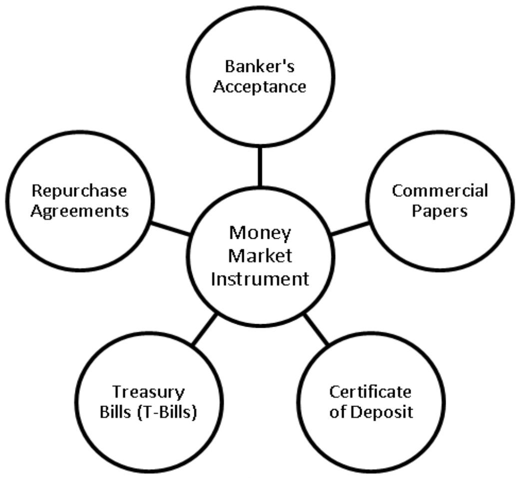

Fig. 4. Money market figure instruments (Source: created by authors)

Money Market Index: To decide how much and where to invest in money market an investor will refer to the Money Market Index. It provides information about the prevailing market rates. There are various methods of identifying Money Market Index like:

– Smart Money Market Index- It is a composite index based on intra day price pattern of the money market instruments.

– Salomon Smith Barney's World Money Market Index- Money market instruments are evaluated in various world currencies and a weighted average is calculated. This helps in determining the index.

– Banker's Acceptance Rate- As discussed above, Banker's Acceptance is a money market instrument. The prevailing market rate of this instrument i.e. the rate at which the banker's acceptance is traded in secondary market, is also used as a money market index.

– LIBOR/MIBOR- London Inter Bank Offered Rate/ Mumbai Inter Bank Offered Rate also serves as good money market index. This is the interest rate at which banks borrow funds from other banks.

As the world interest rate rises relative to the Lithuanian interest rate, investors move capital overseas to enjoy a higher rate of return and reduce the demand for Lithuanian stocks and stock prices. On the other hand, a higher world interest rate causes the foreign currency to appreciate, makes Lithuanian-made products cheaper, and helps raise net exports, and increases businesses and stock prices. The contagion effect suggests that Lithuania's stock market is linked to and affected by the world stock market. Thus, Lithuania's stock market index responds positively (negatively) to an increase (a decrease) in the U.S. and other major stock market indexes.

4. Use of international financial reporting standards around the world

In 2005, thousands of companies around the world – particularly in Europe and the Asia-Pacific area – switched from their national accounting standards to International Financial Reporting Standards (IFRSs). This "big bang" adoption took a lot of hard work on the part of the preparers of financial statements, their auditors and others. Early indications are that the effort was well worthwhile from the perspective of investors, lenders and fund managers, who acknowledge that IFRSs have provided valuable new insights into companies' financial condition and performance. And since financial markets attract seekers and providers of capital across political borders, the financial statement comparability that IFRSs provide is another major benefit from the perspective of the user of financial statements. Use of IFRSs for domestic reporting by listed companies (Table 1).

Table 1. Use of IFRSs around the world (Source: Deloitte, Touche, Tohmatsu, IFRS in Your Pocket 2006, fifth edition)

Location	IFRS not permitted	IFRS permitted	Required for some domestic listed companies	Required for all domestic listed companies
Uzbekistan	X			
Lithuania				X(a)
China			X	
Estonia				X(a)
Finland				X(a)
France				X(a)
Germany				X(a)
Hong Kong				X(c)
India	X			
Japan	X			
Kazakhstan			Banks	
Korea (South)	X			
Kyrgyzstan				X(a)
Latvia				X(a)
New Zealand				2007(b)
Russian Federation			X	start 2006
Switzerland		X		
Tajikistan				X
United States	X			
Uruguay	X(d)			

Some remarks:

a) Audit report refers to IFRSs as adopted by the EU;

b) Compliance with IFRS is stated in a note;

c) IFRSs adopted virtually in full as national GAAP;

d) By law, all companies must follow IFRSs existing at 19 May 2004. The auditors report refers to conformity with Uruguayan GAAP.

In Australia, Brazil, India and Holland and other countries, international standards are used as a basis for developing their own standards, and in countries which decided not to develop its own standards (Cyprus, Malaysia, Nigeria, Fiji, Sri Lanka, etc.) international standards can be fully utilized as a national. In most developed countries with their specific national auditing standards (Canada, UK, Ireland, USA), international standards simply takes note of the professional organizations. Growing numbers of countries are adopting IFRS. The historic 2002 Norwalk Agreement – between the US standard setter, FASB and the IASB – called for "convergence" of the respective sets of standards, and indeed a number of revisions of either US GAAP or IFRS have already taken place to implement this commitment, with more changes expected in the immediate future. The aim of the Boards was to complete the milestone projects of the Memorandum of Understanding (MOU) by the end of June 2011. These milestone projects include:

– Financial Instruments,
– Consolidations,
– Derecognition,
– Fair value measurement,
– Revenue recognition,
– Leases,
– Financial Instruments with characteristics of equity,
– Other MOU projects,
– Other joint projects.

4.1. International standards: what is convergence and whether there is any like hood of convergence between Asian and European financial organizations

The development of financial reporting rules for financial instruments just described has provided users of financial reports with substantial new information about how firms generate or destroy value using these instruments.

Uzbekistan has not fully adopted IFRS (Deloitte, Touche 2003). However, it is trying to converge to an extent with IFRS. In 1998, there has been an accounting reform in Uzbekistan for the development of a series of the first National Accounting Standards that were based upon IAS (Narayan, Reid 2000). Some of these standards were first drafted in 1997, but a few of them were approved in 1998 by the Ministry of Finance. At present, there are 21 standards effective in Uzbekistan (Balchenko 2001). Each standard is based on the relevant international standard, but there are differences between respective local and international standards. In essence, Uzbekistan is in the first stage of the adoption process of IFRS.

IFRS is required for all commercial banks. IFRS and IFRS for SMEs are prohibited for other companies‘ statutory filings. However, other entities can also use IFRS together with statutory rules, since there is no restriction in use of IFRS for any type of entities (foreign entities or joint ventures, etc). The local standard setting body has not announced any adoption plans; however, there is a step by step convergence plan of local GAAP with IFRS.

The debate surrounding the adoption of IFRS in Europe initially focused on the merits of adopting IFRS, such as whether the benefits of the expected increased capital flows would outweigh the costs of implementation and lost diversity in domestic accounting standards. The debate later centered on IAS 39 *Financial Instruments: Recognition and Measurement* and, to a lesser extent, on IAS 32 *Financial Instruments: Disclosure and Presentation*. The provisions in these two standards, particularly IAS 39, had the potential to materially affect financial statement amounts for firms with a large number of financial instruments, notably banks. The debate regarding IAS 39 ultimately led to the modification of IAS 39 for adoption in Europe. Modifications to IAS 39, or any other IASB standard, undermine the EU’s goal of adopting global standards.

4.2. The practice of international standards

The IAS/IFRS (International Accounting Standards/International Financial Reporting Standards) consist of a set of international accounting principles, the adoption of which aims at establishing clear rules within the European Union to draw up comparable and transparent annual reports and financial statements. Their adoption represents an essential element to obtain an integrated, competitive and attractive European capital market, which has impelled the European Commission to introduce this set of uniform accounting stadards for listed EU companies.

Financial reporting for financial instruments and institutions is undergoing a period of unprecedented change and relavence for financial analysis. In the past decade, the Financial Accounting Standards Board (FASB) has issued major standards on derivatives and hedging, transfers of financial Instruments including securitizations servicing of financial assets, consolidation of special purpose interest entities, hybrid financial instruments, financial guarantees, and fair value measurements.

4.3. Financial market of Lithuania

Accordingly, a lot of companies with participation of foreign capital have been establishing lately. So, under these circumstances there is a need for proper organization of business activity of joint ventures and companies with foreign investments. The financial intermediaries licensed in Lithuania can offer from the range mentioned above all financial instruments traded on and off the regulated Lithuanian market and can act as intermediaries almost in all financial markets of the world.

The restored financial market of Lithuania is quite young, it has moved to only the third decade. Its establishment gave rise to the need to thoroughly analyse the ongoing processes, make analysis, and statistical calculations. The complex analysis is needed both with regard to investor and the issuer of the financial instrument for theBank of Lithuania, the Central Securities Depository of Lithuania, and the Securities Commission of the Republic of Lithuania. Following the Council

Regulation (EC) No 2223/96 of 25 June 1996 on the European system of national and regional accounts in the Community, the institutions mentioned above have prepared the Rule on the Submission of Information on the Owners of Securities, Balances of Securities and Financial Flows (2005). Drafting of the Rule was based on the May 16, 2001 Decision No 569 of the Government of the Republic of Lithuania on the Implementation of the European System of National and Regional Accounts (ESA'95). According to the Rule the owners of financial instruments, also called securities, are grouped into Lithuanian residents, European Union residents, except for the Republic of Lithuania, and non-residents.

Lithuanian financial system is dominated by the banking sector with only a minority of assets held by other types of firms (capital market, insurance, leasing of credit unions). As well as the whole economy, financial system has suffered from the losses in the period of the recession. Banking sector has maintained its stability and no major disturbances in the market occurred even though the situation was tough. Today the financial sector is on its way for a rebound. Its path will depend on the general state of the Lithuanian economy wich is still subject to risks from the foreign markets. However, many areas of Lithuanian financial services are underdeveloped compared to the Western economies, thus the long term potential is yet to be unveiled.

In general for transition economies the following barriers for derivatives markets can be presented (Kilcollin, Frankel 2003):

– Awareness and understanding of derivatives;

– Domestic laws and regulations inhibiting such investments;

– Limits on access to brokerage services;

– Cost of entering a new market;

– Increased risks;

– Lack of adequate infrastructure;

– Lack of customers.

In developed countries derivatives markets fulfil important roles of price discovery and hedging opportunities. Therefore I see the future of the derivatives market in transition economies in general and in Uzbekistan in particular, as at least a long-run prospect.

5. Conclusions

New forms of businesses in foreign activity of Uzbekistan result in occurrence of new problems. Selection of a partner in the international market, on which the future collaboration depends, is one of the problems. The methods of efficiency analysis of enterprises applied abroad are different from the ones in Uzbekistan. New economic relations linked with gradual transfer of the economy to the usage of market mechanisms, create new problems in organization and methodology of financial system. Development of market economy does not tolerate insularity of national economy, but in opposite, it assumes free cross board movement of goods, capital and workforce. Broad international relations, including expanding foreign investments into the economy of Uzbekistan.

This is stipulated by development of world economy, requiring between companies, operating in the international market. From the other hand, restructuring of the theoretical basis in Uzbekistan requires profound understanding of the substance of international standards and the opportunity of their application in practiceThese letters contain errors and omissions noted, and recommendations for corrections. Development of financial system in Uzbekistan resquires immediate solution of the following issues:

– Use the methodologies based on international standards for grouping of financial instruments and investors;

– Enhance international integration of trade and settlement systems and promote creation of new high technologies in this sphere in Uzbekistan;

– Encourage arrival of new issuers into the market;

– Development of financial standards and norms considering international experience and peculiarities of the national accounting standards;

– Development of the recommendations on generally accepted forms of investor opinion and programs.

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