Moving towards Fair Value – IFRS 13 in Indian Perspective

The Ministry of Corporate Affairs (MCA) has notified Ind-AS, but the implementation road-map is yet to be announced. The newly drafted standards extensively talk about fair value measurement. The International Accounting Standards Board (IASB) has issued "IFRS 13 - Fair Value Measurement" which provides detailed guidance on measurement principles and valuation techniques w.r.t. fair valuation of assets and liabilities. The valuation techniques and measurement principles given in this standard can be applied in a consistent manner while determining the fair value in various situations under the Indian regulatory scenario.

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Concept of Fair Value

The Institute of Chartered Accountants of India (ICAI) has drafted "Indian Accounting Standard" (Ind AS) which are notified by the Ministry of Corporate Affairs (MCA). The Ind-AS notified by the MCA is based on the principles of IFRS with certain carve outs and exclusions after considering the local economic environment. The newly drafted standards extensively talk about the use of fair value (FV) accounting and it becomes necessary to measure the transaction at fair value unless excluded or some other method of measurement is provided.

Fair Value is defined as "*the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction*", but the notified Standards do not provide specific guidance as to how the fair value has to be determined in various cases.

Developments in the International Arena

The International Accounting Standards Board (IASB) has issued "IFRS 13 - *Fair Value Measurement*" which is effective from period beginning 1st January 2013 for a number of reasons. The main reason behind coming up with a specific standard on fair valuation was to reduce the complexity and improve consistency in application when measuring fair value. Many standards require or permit entities to measure or disclose the assets/liabilities at fair value, but prior to issuance of IRFS 13 the guidance on how to measure fair value was very much limited. IFRS 13 requires extensive disclosures on the measurement techniques and assumptions used in the determination of the fair value and thus it will help to improve the transparency of the financial statements.

Key Principles under IFRS 13

IFRS 13 (Standard) defines fair value as "*The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date*". The standard provides detailed guidance on the measurement and disclosure requirements. The standard stipulates the following factors that should be considered in fair value measurement-

i. the asset or liability
ii. the transaction
iii. market participants
iv. the price

In addition to the above, specific consideration is given to -

i. non-financial assets
ii. liabilities
iii. equity
iv. financial instruments

We shall touch upon every aspect one by one-

i. The asset or liability- A fair value measurement relates to a particular asset or liability. It should, therefore, incorporate the asset or liability's specific characteristics if market participants consider these characteristics when pricing the asset or liability. These characteristics have to be seen from the perspective of the market participants and not from the seller's perspective.

Fair value is focused on the assumptions of the marketplace and it is not entity specific and accordingly the concept of exit price is based on the current expectations about the sale or transfer price from the perspective of market participants. Even if an entity intends to hold an asset, the exit price based valuation is still appropriate because it reflects the expectation of the future cash flow from the perspective of a market participant who will use it in the same way.

Although the fair value is determined for a particular asset or liability but the measurement may be applied on a group of assets or liability based on the level at which the asset or liability is aggregated or disaggregated in accordance with the IFRS requirements applicable to the particular asset or liability being measured. For example, a group of assets may be taken together which form part of Cash generating Unit for the purpose of fair value determination under IAS 36 - Impairment of Assets.

ii. The transaction- Under this standard, the management determines the air value based on a transaction that would take place in the principal market or, in its absence, the most advantageous market. If there is a principal market, the price in that market must be used even if prices in other markets are more advantageous. If there is no principal market then the price in the most advantageous market shall be the fair value.

The principal market is defined as the market with the greatest volume and level of activity for the asset or liability. In order to determine the principal market, the management needs to evaluate the level of activity in various different markets but there is no need to undertake an exhaustive search of all possible markets. The price in the principal market gains its significance from the fact that the management has to consider the prevailing price in principal market only even if other markets also exist which are more advantageous. The principal market or most advantageous market has to be determined on the basis of ability of the entity to access that market on the reporting date. Since different reporting entities may have access to different markets, the principal or most advantageous markets could vary between entities.

iii. Market participants- The standard requires that while determining the fair value of the assets & liabilities, the management uses the assumption that market participants would use when pricing the asset or liability. Market participants are buyers and sellers in the principal (or most advantageous) market for the asset or liability that are:

- Independent of each other (i.e. they are not related parties as defined in IAS 24). However, the transaction price for related party transaction can also be used if there is evidence that the transactions were on market terms.
- knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information, including information that might be obtained through usual and customary due diligence.
- able to enter into the transaction.
- willing to enter into the transaction for the particular asset or liability.

iv. The price- Fair value is always based on exit price (i.e. the price that would be received to sell an asset or would be paid to discharge a liability). Transaction price (i.e. entry price) is not the fair value as per the standard.

Fair value is focused on the assumptions of the marketplace and it is not entity specific and accordingly the concept of exit price is based on the current expectations about the sale or transfer price from the perspective of market participants. Even if an entity intends to hold an asset, the exit price based valuation is still appropriate because it reflects the expectation of the future cash flow from the perspective of a market participant who will use it in the same way.

Any restriction/encumbrance on the use or sale of asset will impact the fair value for example the value of a freehold property and leasehold property will not be the same.

Transition date (roadmap) of Ind-AS has not been announced yet and the standards notified by MCA doesn't include a parallel standard in line with IFRS 13 for the measurement of assets and liabilities. However, the valuation techniques and measurement principles given in this standard can be applied in a consistent manner while determining the fair value (like business valuation of listed companies in case of merger/demerger as per SEBI guidelines, various certificates issued for valuation purpose etc.).

For the determination of price, the standard prohibits the adjustment of transaction cost. However it requires the transaction cost to be adjusted from the price while determining the most advantageous market. The transaction cost doesn't include transportation cost. Following example will illustrate it better.

		Amount (₹)
	Market I	**Market II**
Price	300	325
Transportation cost	30	50
	270	**275**
Transaction cost	20	10
Net Amount	**250**	**265**

If Market I is the principal market then the fair value shall be determined at Rs. 270 after taking into the transportation cost. If there is no principal market then the fair value shall be determined at Rs. 275 for Market II as it is the most advantageous market.

Specific Considerations

Specific consideration has been given for the measurement of non-financial assets, liabilities, equity and financial instruments.

i. Consideration to measurement of non-financial assets- Fair value of a non-financial asset to be measured based on its highest and best use from a market participant's perspective. The highest and best use takes into account the physical characteristics (like location of the property), legal restrictions (like encumbrance over use of the property) and its financial feasibility (i.e. the asset is able to generate sufficient future cash flow). While determining the highest & best use, the management should consider all costs which a market participant will incur. For example, if the entity is currently using any land for farming purpose but the market participants wants to use the same for residential complex purpose then all costs (e.g. legal costs etc.) have to be considered.

ii. Consideration to measurement of non-financial liability or equity- Fair value of non-financial liability is measured at the transfer price. The transfer price valuation of liability assumes the following -

- A liability would remain outstanding and the market participant transferee would be required to fulfil the obligation. The liability would not be settled with the counterparty or otherwise extinguished on the measurement date.
- An entity's own equity instrument would remain outstanding and the market participant transferee would take on the rights and responsibilities

associated with the instrument. The instrument would not be cancelled or otherwise extinguished on the measurement date.

Therefore, the liability or equity is to be valued on the measurement date after taking into consideration that the liability will not be extinguished (i.e. will be taken over by the transferee and will be settled by him in future) and the equity will remain in the books of the entity.

iii. Consideration to measurement of financial instruments- Fair value of the financial instrument has to be determined after considering various factors like credit risk/non-performance risk, value of the quoted instruments etc.

Valuation Techniques and Fair Value Hierarchy

I. Valuation Techniques

The standard describes three valuation techniques that may be used to determine fair value.

- **Market approach:** Under this approach market price of the similar assets or liabilities is taken for determining fair value. This technique is mostly used in case of listed securities or other instruments which are traded in the secondary market or money market.
- **Income approach:** Under this approach the future cash flows are considered for determining the cash flow. The discount rate used for determining the present value of income shall be taken from the view of the market participant. This approach is widely used in case of business valuation of unlisted entities.
- **Cost approach:** Under this approach it is assumed that fair value is the cost to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence (including physical deterioration, functional (technological) obsolescence and economic (external) obsolescence). Following process is followed for determination of fair value under cost approach-
  a. Identify new cost of modern equivalent asset
  b. Adjust it for age/economic obsolescence/ deterioration
  c. The resulting value is the depreciated replacement cost which shall be the fair value Cost approach shall only be used when the other approaches are not available or produce unreasonable results.

The standard doesn't prescribe the use of any particular valuation technique for the measurement but recommends that a reporting entity should use the appropriate technique based on facts and circumstances specific to the asset or liability being measured and the market in which they are transacted.

II. Fair Value Hierarchy

The standard prescribes hierarchy of inputs to be used for measurement of assets and liabilities.

Following table summarises the principles-

	Level I	Level II	Level III
Definition	Quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date.	Inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly or indirectly.	Unobservable inputs for the asset or liability
Example	Quoted price for a security frequently traded in an active market.	Interest rates and yield curves, interest rate swap in which rate is observable at commonly quoted intervals.	Discounted cash flow used to value a business

Conclusion

Transition date (roadmap) of Ind-AS has not been announced yet and the standards notified by MCA doesn't include a parallel standard in line with IFRS 13 for the measurement of assets and liabilities. However, the valuation techniques and measurement principles given in this standard can be applied in a consistent manner while determining the fair value (like business valuation of listed companies in case of merger/demerger as per SEBI guidelines, various certificates issued for valuation purpose etc.). The standard has mandated some disclosures which will ensure more transparency which will help users to better assess the valuation techniques and inputs used to measure fair value. ■