Fair Valuation –Pillar under Ind AS

After the Great Depression (1929 – 1939), accounting professionals started to rethink about the accounting rules. The focus was shifted to prescribing standards for measurement and reporting of financial statements. USA took the lead in this direction followed by UK, Australia, Canada and other developed countries. The accounting standards were re-framed by the American Institute of Certified Public Accountants (CPA) in USA. In India this task was given to the Institute of Chartered Accountants of India (ICAI). The need for development of accounting standards has increased due to privatisation and globalisation of Indian Economy. Subsequently, Accounting Standards Board (ASB) was constituted as a body in the year 1977 consisting of representatives from government department, academicians, other professional bodies viz ICAI, representatives from ASSOCHAM, CII, FICCI, etc. First Accounting Standard, AS-1 (Disclosure of Accounting Policies) was issued in 1979. Read on to know more about accounting standards in India…

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Shifting from IGAAP (1979) to Ind AS (2015)

USD 3 trillion was the size of the world economy when the discussion started to have mandatory accounting rules/standards in place for comparability and transparency. Indian economy at that point of time was of USD 27 billion.

The argument for fair value accounting is that it makes accounting information more relevant. However, historical cost accounting is considered more conservative and reliable.

In 1979, when the first accounting standard was issued, Indian economy was at USD 59 billion, primarily dependent upon agriculture. In 1991, when Dr. Manmohan Singh, the then, finance minister implemented policies to open up the economy, size of Indian GDP was USD 1.1 trillion. By this time, share of agriculture and allied services reduced to 29% and service sector has started contributing to Indian GDP. Indian GDP is at USD 2.3 Trillion in 2016 driven primarily by the service sector which has a share of 64% in Indian GDP.

Indian GDP has increased from USD 59 billion in 1979 (implementation of IGAAP) to USD 2.3 trillion in 2016 (shifting to Ind AS). Indian economy has grown by 4 times since the introduction of first accounting standard under IGAAP and hence the need to replace IGAAP with Ind AS have arisen for improved transparency and comparability at international level.

Historical Cost under IGAAP Vs Fair Valuation under Ind AS Regime

Accounting is the language of business and accounting standards are set of rules to be followed for fair representation of facts of business. Business is dynamic in nature and changes over time, hence it is important to make necessary modifications in business language for transparency.

Historical cost is the original cost of an asset, as recorded in an entity's accounting records. Advantages from accounting perspective is as below:

1. Simplicity, cost effective method of asset valuation
2. Conservative, does not account for asset appreciation, regular reduction applying depreciation, Impairment testing at regular intervals.

Historical Cost concept is best suited for economies:

- With no inflation, or
- Rate of inflation can be ignored.

The argument for fair value accounting is that it makes accounting information more relevant. However, historical cost accounting is considered more conservative and reliable.

Fair value accounting was blamed for some dubious practices in the period leading up to the Wall Street crash of 1929, and was virtually banned by the US Securities and Exchange Commission from the 1930s till 1970s. Yet US GAAP and IFRS which was adopted by nearly 200 countries worldwide, continue to use fair value extensively.

On one hand where *historical cost* concept is the *real* cost of asset/liability, *fair valuation* is *judgemental* and factors inflation for fair representation of balance sheet items at a particular date.

Ind AS – 113: Fair Value Measurement

Notified Ind AS – 113 *Fair Value Measurement* has been developed in line with IFRS – 13 – *Fair Value Measurement* issued by International Accounting Standards Board in May 2011. The standard defines fair value and sets out in a single Ind AS a framework for measuring fair value.

Overview

This standard:

- Defines fair value
- Sets out a framework for measuring fair value
- Requires disclosure about fair value measurement.

Scope

This Standard applies when another Standard requires or permits fair value measurements or disclosures.

Measurement and Disclosure requirements of this IFRS do not apply to:

- Share based payment transactions – Ind AS – 102: Share Based Payment
- Leasing Transactions within the scope of Ind AS 17: Leases
- Measurements that have some similarities to fair value but are not fair value, such as Net Realisable Value in Ind AS 2: Inventories and Value in Use in Ind AS 36: Impairment of Assets.

Disclosures required by this Ind AS are not required for the following:

- Plan assets measured at fair value in accordance with Ind AS 19 Employee Benefits;
- Asset for which recoverable amount is fair value less cost of disposal in accordance with Ind AS 36

This Standard is applicable for both initial and subsequent measurement if fair value is required or permitted by other Ind ASs.

Measurement

Fair value:
It is 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*.

Asset and Liability

1. Fair Value measurement of a particular asset or liability depends upon the characteristic attached to it, measurement will differ depending on how that characteristic would be taken in account by market participants. Such characteristics include, for example, the following:
   - Condition and location of the asset; and
   - Restrictions, if any, on the sale or use of the asset.

The Transaction

2. Fair Value measurement assumes that the transaction to sell asset or transfer liability takes place either:
   - In the *principal market* for the asset or liability;
   - In the absence of principal market, in the *most advantageous market* for the asset or liability.

   Here it is important to note that:
   i. The entity need not undertake an exhaustive search of all possible markets to identify principal market or most advantageous market, but should take into account all information that is reasonably available.
   ii. If there is a principal market for the asset or liability, the fair value measurement shall represent the price in that market, even if price is higher in different market.
   iii. The entity must have access to the principal market at the measurement date.
   iv. Although an entity is having the access to the market, it is not necessary to be able to sell it in order to determine Fair Value of asset.

Market Participants

3. An entity shall measure the fair value of an asset or a liability using the assumption that market participants would use when pricing the asset or a liability, assuming that market participants act in their economic best interest.

The Price

4. Fair Value is the *price* that would be received to sell an asset or paid to transfer a liability, regardless of whether that price is *directly observable* or *estimated* using another *valuation technique*.
   It is to be noted that:
   i. The price in the *principal market* (or most advantageous market) shall not be adjusted for transaction cost as transaction cost is not a characteristic of an asset or a liability.
   ii. Transaction costs do not include *transport costs*. If location is a characteristic of the asset, the price in the principal market shall be adjusted for the costs, if any.

Application to Non Financial Assets:
A *fair value* measurement of *a non financial asset* takes into account a market participant's ability to *generate economic benefits* by using the asset in its *highest and best use*.

Highest and best use takes into account the use of the asset that is physically possible, legally permissible and financially feasible.

Fair Value at Initial Recognition:
Initial Recognition = Transaction Price (Entry / Exit Price)

1. Entry price: The price paid to acquire the asset or received to assume the liability

2. Exit price: The price that would be received to sell an asset or paid to transfer the liability.

Note:
- In most cases the transaction price will equate the fair value
- If another Ind AS requires an entity to measure an asset or a liability initially at fair value which is different from transaction price, the entity shall recognise the resulting gain or loss unless that Ind AS specifies otherwise.

A fair value measurement of a non financial asset takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use.

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Valuation techniques used to measure fair value shall maximise the use of relevant observable inputs and minimise the use of unobservable inputs.

Valuation Techniques

An entity shall use valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value, maximising the use of relevant observable inputs and minimising the use of unobservable inputs.

Here it should be noted that:

- Objective of using a valuation technique is to estimate the price at which an orderly transaction takes place. Three widely used valuation techniques are
  a) The Market Approach
  b) The Cost Approach
  c) The Income Approach.
- Valuation techniques used to measure fair value shall be applied consistently. However, a change in a valuation technique or its application is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances. That might be the case if, for example, any of the following events take place:
  - New Market develops;
  - New Information becomes available;
  - Information used previously is no longer available;
  - Valuation technique improves;
  - Market condition changes.
- Revision resulting from a change in the valuation technique or its application shall be accounted for as a change in accounting estimate in accordance with Ind AS 8. However, the disclosures as per Ind AS 8 are not required.

Inputs to Valuation Techniques

Valuation techniques used to measure fair value shall maximise the use of relevant observable inputs and minimise the use of unobservable inputs.

Fair Value Hierarchy:
The Fair Value Hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1 Inputs) and the lowest priority to Unobservable Inputs (Level 3 Inputs)

LEVEL 1 INPUTS

Level 1 Inputs are Quoted Prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date.

A *quoted price* in an active market provides most reliable evidence of fair value and shall be used without adjustment to measure fair value whenever available except in following circumstances:

- When an entity holds a large number of similar (not identical) assets or liabilities that are measured at fair value and a quoted price in an active market is available but not readily accessible for each of those assets or liabilities individually.
- When a quoted price in an active market does not represent fair value at the measurement date. That might be the case if, for example, significant events take place after the close of a market but before the measurement date. Entity shall establish and consistently apply a policy for identifying those events that might affect fair value measurements.

Level 1 input will be available for many financial assets and financial liabilities, some of which might be exchanged in multiple active markets. Therefore, the emphasis within level 1 is on determining both of the following:

- The principal market for the asset or liability or, in the absence of a principal market, the most advantageous market.
- Whether the entity can enter into a transaction for the asset or liability at the price in that market at the measurement date.

LEVEL 2 INPUTS

Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.

Asset or Liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability. Level 2 inputs include the following:

- Quoted prices for similar assets or liabilities in active markets.

- Quoted prices for identical or similar assets or liabilities in markets that are not active.
- Inputs other than quoted prices that are observable for the asset or liability, for example;
  - o Interest rates and yield curves observable at commonly quoted intervals;
  - o Implied volatilities; and
  - o Credit spreads.
- Market – Corroborated inputs.

Adjustments to Level 2 inputs will vary depending on factors specified to the asset or liability. Those factors include the following;

- The condition or location of the asset;
- The extent to which inputs relate to items that are comparable to the asset or liability; and
- The volume or level of activity in the markets within which the inputs are observed.

LEVEL 3 INPUTS

Level 3 inputs are unobservable inputs for the asset or liability.

Unobservable inputs shall be used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date.

Assumption about risk include the risk inherent in a particular valuation technique used to measure fair value and the risk inherent in the inputs to the valuation technique. A measurement that does not include an adjustment for risk would not represent a fair value measurement if market participants would include one when pricing the asset or liability.

Entity shall develop unobservable inputs using the best information available in the circumstances, which might include the entity's own data. In developing unobservable inputs, an entity may begin with its own data, but it shall adjust those data if reasonable available information indicates that other market participants would use different data or there is something particular to the entity that is not available to other market participants.

A measurement that does not include an adjustment for risk would not represent a fair value measurement if market participants would include one when pricing the asset or liability.

Disclosure

An entity shall disclose information that helps users of its financial statements assess both of the following:

1. For assets and liabilities that are measured at fair value on a recurring or non-recurring basis in the balance sheet after initial recognition, the valuation techniques and inputs used to develop those measurements.
2. For recurring fair value measurements using significant unobservable inputs (Level 3), the effect of measurement on profit or loss or other comprehensive income for the period.

An entity shall disclose, at a minimum, the following information for each class of assets and liabilities measured at fair value:

- For recurring and non-recurring fair value measurement, the fair value measurement at the end of the reporting period, and for non-recurring fair value measurements, the reason for the measurement.
- Recurring fair value measurements of assets or liabilities are those that other Ind AS's require or permit on each reporting period. Non Recurring fair value measurements of assets or liabilities are those that other Ind AS's require or permit in the balance sheet in particular circumstances (e.g. Ind AS 105, Non Current Assets Held for Sale and Discontinued Operations)
- For recurring and non-recurring fair value measurements, the level of the fair value hierarchy within which the fair value measurements are categorised (Level 1, 2 or 3)
- For assets and liabilities held at the end of the reporting period that are measured at fair value on a recurring basis, the amounts of any transfers between *Level 1* and *Level 2* of the fair value hierarchy, the reasons for those transfers and entity's policy for determining transfers.
- Change in Valuation techniques to be disclosed separately along with reasons for the same.
- For recurring fair value measurements categorised within Level 3 of the fair value hierarchy, a reconciliation from the opening balances to the closing balances, disclosing separately changes during the period attributable. ■