IND AS – 113 FAIR VALUE MEASUREMENT

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- Application of fair value measurement
- Valuation techniques
- Fair value hierarchy and inputs
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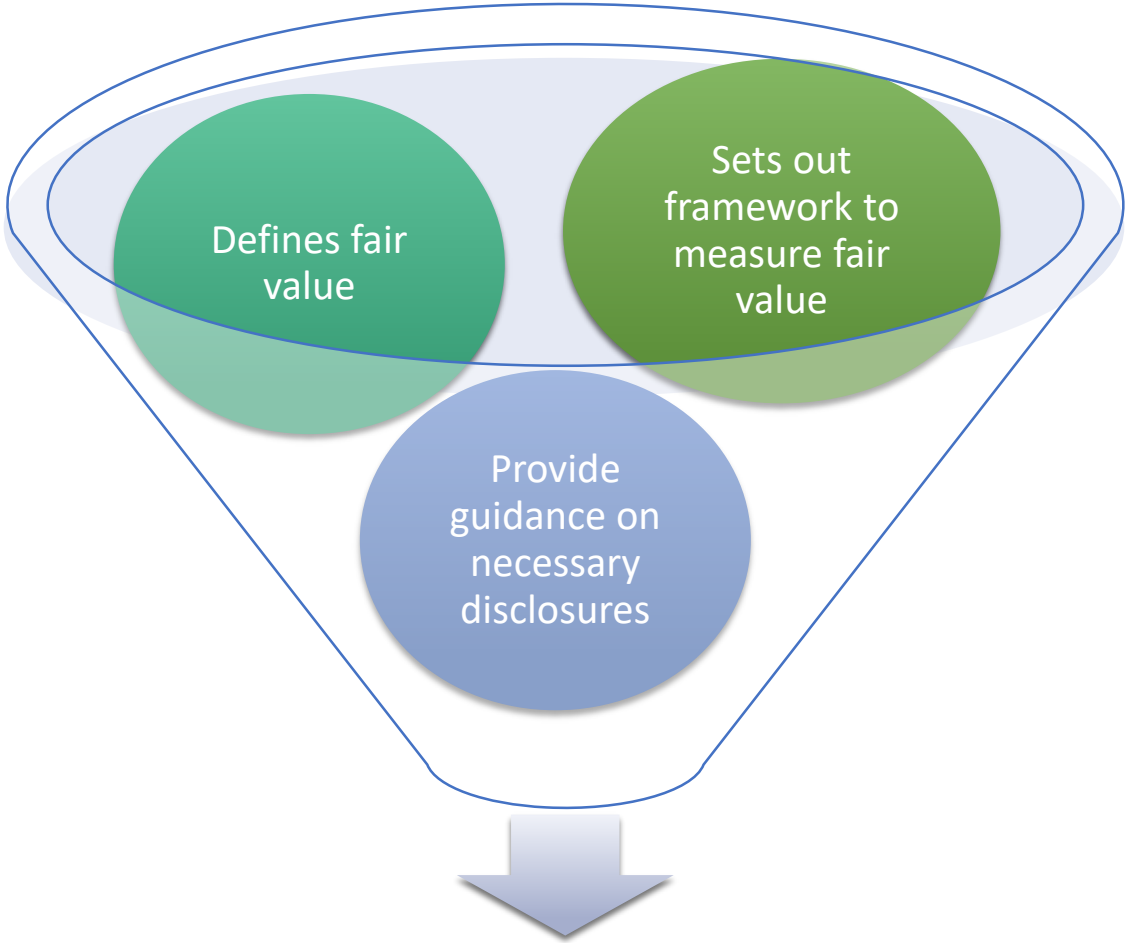
OVERVIEW, OBJECTIVE & SCOPE

OVERVIEW

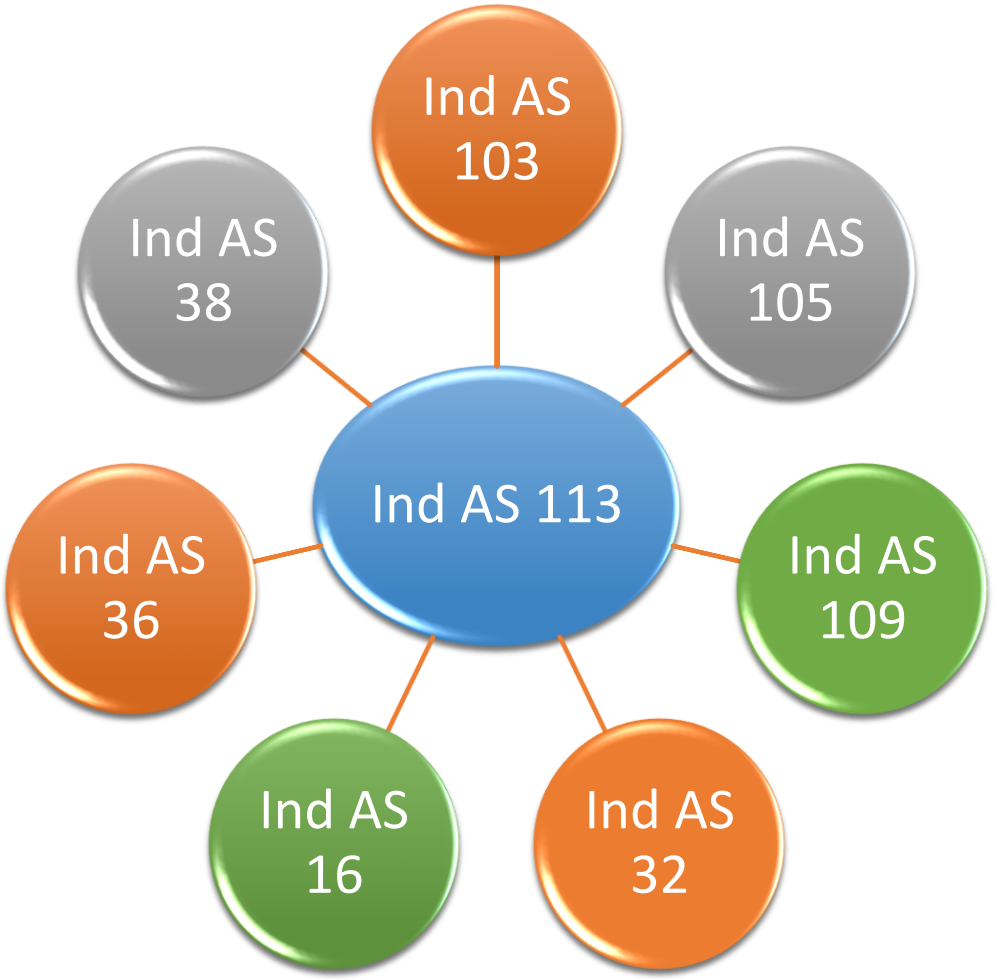
- Adoption of Ind AS will improve comparability, transparency and quality of financial statements
- Fundamental changes brought in by Ind AS:
  - More express guidance
  - Substance over form
  - Present value and fair value concepts
  - Detailed disclosures
- One of the key change is introduction of ‘fair value’ (“FV”) concept
- Ind AS 113 sets out a framework for measuring ‘fair value’

OBJECTIVES


Defines fair value
Sets out framework to measure fair value
Provide guidance on necessary disclosures
Ind AS 113

SCOPE OF IND AS 113

- Applies when another Ind AS **requires** or **permits** fair value **measurements** or **disclosures**
- Applies to both **initial** and **subsequent** fair value measurement
- Ind AS 113 **does not** address which types of assets / liabilities should be measured / disclosed at fair value



SCOPE OF IND AS 113

Ind AS 103
Business Combination

- Identifiable assets and liabilities of the acquiree to be measured at FV
- Non-controlling interest to be measured at FV
- Previously held equity interest to be measured at FV on a step acquisition

Ind AS 105
Non current asset held for sale and discontinued operation

- Non current assets and/ or disposal groups to be measured at lower of carrying cost and FV less costs to sell

SCOPE OF IND AS 113

Ind AS 109 Financial Instrument	• Financial instruments which are to be recognised and measured at FV as per Ind AS 109
Ind AS 32 Financial Instruments: Presentation	• Fair Valuation of a compound financial instruments as a whole and FV of the liability component

SCOPE OF IND AS 113

Ind AS 16 Property plant and equipment	• Items that are measured using the revaluation model.
Ind AS 36 Impairment of assets	• Recoverable amount is determined based on “FV less cost of disposal”

SCOPE OF IND AS 113

Ind AS 38 Intangible assets	• Items that are measured using the revaluation model at FV
Interpretations	• Appendix A to Ind AS 10 Distributions of Non-cash Assets to Owners

SCOPE EXEMPTION

Measurement and disclosure requirements of Ind AS 113 does not apply

- Share-based payment transactions within the scope of Ind AS 102, Share based payment
- Leasing transactions within the scope of Ind AS 17, Leases
- Measurements which have similarities to FV but are not FV (e.g. net realisable value in Ind AS 2, Inventories and value in use in Ind AS 36, Impairment of Assets)

SCOPE EXEMPTION

Disclosure requirements of Ind AS 113 does not apply

- Plan assets measured at FV in accordance with Ind AS 19, Employee Benefit
- Assets for which recoverable amount is FV less costs of disposal in accordance with Ind AS 36, Impairment of assets

GUIDANCE

- Defines FV and lays down the key principles in measuring FV
- Application of FV measurement principles
- Determination of appropriate valuation techniques
- Application of FV hierarchy

FAIR VALUE AND KEY CONCEPTS

DEFINITION OF FAIR VALUE

The Fair value is a 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

Price →	Exit price at measurement date
Measurement date →	Date as mentioned in applicable Ind AS
Orderly transaction →	Not a forced or a distress sell
Market participants →	Not entity specific

KEY FACTORS TO BE CONSIDERED IN DETERMINING THE FAIR VALUE

- Particulars of the asset and liability that is subject of the measurement
  - Unit of account
  - Characteristics of the assets and liabilities
- The principal (or most advantageous) market for the asset or liability
- The market participants
- The price

UNIT OF ACCOUNT

- FV measurement can be applied to
  - either a standalone asset or liability (e.g. an equity instrument, investment property etc.)

  or

  - a group of related assets and/or liabilities (e.g. CGU)

- The unit of account for the asset or liability should be determined in accordance with the Ind AS that requires or permits the fair value measurement, except provided under Ind AS 113
- For e.g. Unit of account in case of Ind AS 36, Impairment of assets is a CGU whereas in case of Ind AS 109 it is generally a financial instrument

UNIT OF ACCOUNT

- A FV measurement should consider the specific characterises of the asset or liability, if the market participants consider them when pricing such asset or liability.
- Examples of such characteristics could include:
  - The condition and location of an asset, and
  - Restrictions, if any, on the sale or use of an asset or transfer of a liability.
- For example: Industrial Leasehold Land

THE MARKET

- FV to be determined based on a hypothetical transaction that would take place in the principal market or, in absence, the most advantageous market
- *Principal Market* :
  - The market with the greatest volume and level of activity for the asset or liability.
- *Most advantageous Market* :
  - The market that maximises the amount that would be received to sell the asset or minimise the liability, after taking into account transaction cost and transport cost.
- In absence of evidence to determine the principal market, the market in which the entity normally transacts is presumed to be the principal market or most advantageous market.

THE MARKET

Illustration :

- Co. A has an asset which is sold in two different markets with similar volume activities but with different price. Company has an access to both the markets and there is no principal market for the asset.

Particulars	Market X (INR)	Market Y (INR)
Price	25	27
Cost of transport	2	4
Cost of transaction	3	4
Net realisable amount	20	19

- Co. A would maximise the net amount that would be received on sale of asset in Market X. Therefore Market X is the most advantageous market.

THE PRICE

- The price in the principal (or most advantageous) market used to measure FV to consider the following:
- ***Adjust***: Transportation cost
  - If the location is a key characteristic of the asset the price to be adjusted for transportation cost that would be incurred to bring the asset from its current location to the principal (or most advantageous) market
- ***Do not adjust***: Transaction cost
  - Not a characteristic of the asset or liability; rather it would be specific to a transaction

MARKET PARTICIPANTS

- Buyers and sellers in principal (or most advantageous) market for assets and liabilities
- Characteristics of Market Participants are:
  - They are independent of each other
  - They are knowledgeable, having reasonable understanding of assets and liabilities
  - They are able to enter into a transaction for the assets and liabilities
  - They are willing to enter into a transaction (not forced)

APPLICATION OF FAIR VALUE MEASUREMENT

FAIR VALUE AT INITIAL RECOGNITION

Fair Value	Transaction Price
Price that would be received to sell the asset or paid to transfer the liability **(Exit Price)**	Price paid to acquire the asset or received to assume the liability **(Entry Price)**

In many cases the Transaction price will equal the FV e.g. on the transaction date the transaction to buy an asset takes place in the market in which the asset will be sold.

Transaction price might not represent the FV if:

- The transaction is between related parties
- The transaction is a duress sale
- The unit of account is different (e.g. Business Combination)
- The transaction does not take place in principal or most advantageous market

APPLICATION OF FAIR VALUE MEASUREMENT TO LIABILITIES AND THE ENTITY'S OWN EQUITY INSTRUMENT

- Liability

FV is the price paid to transfer the liability and not settle

Assumptions

- Liability is transferred to a market participant, not settled
- The liability remains outstanding and the market participant transferee would be require to fulfil the obligation
- Regardless of whether the reporting entity has the ability to transfer its liability to someone else

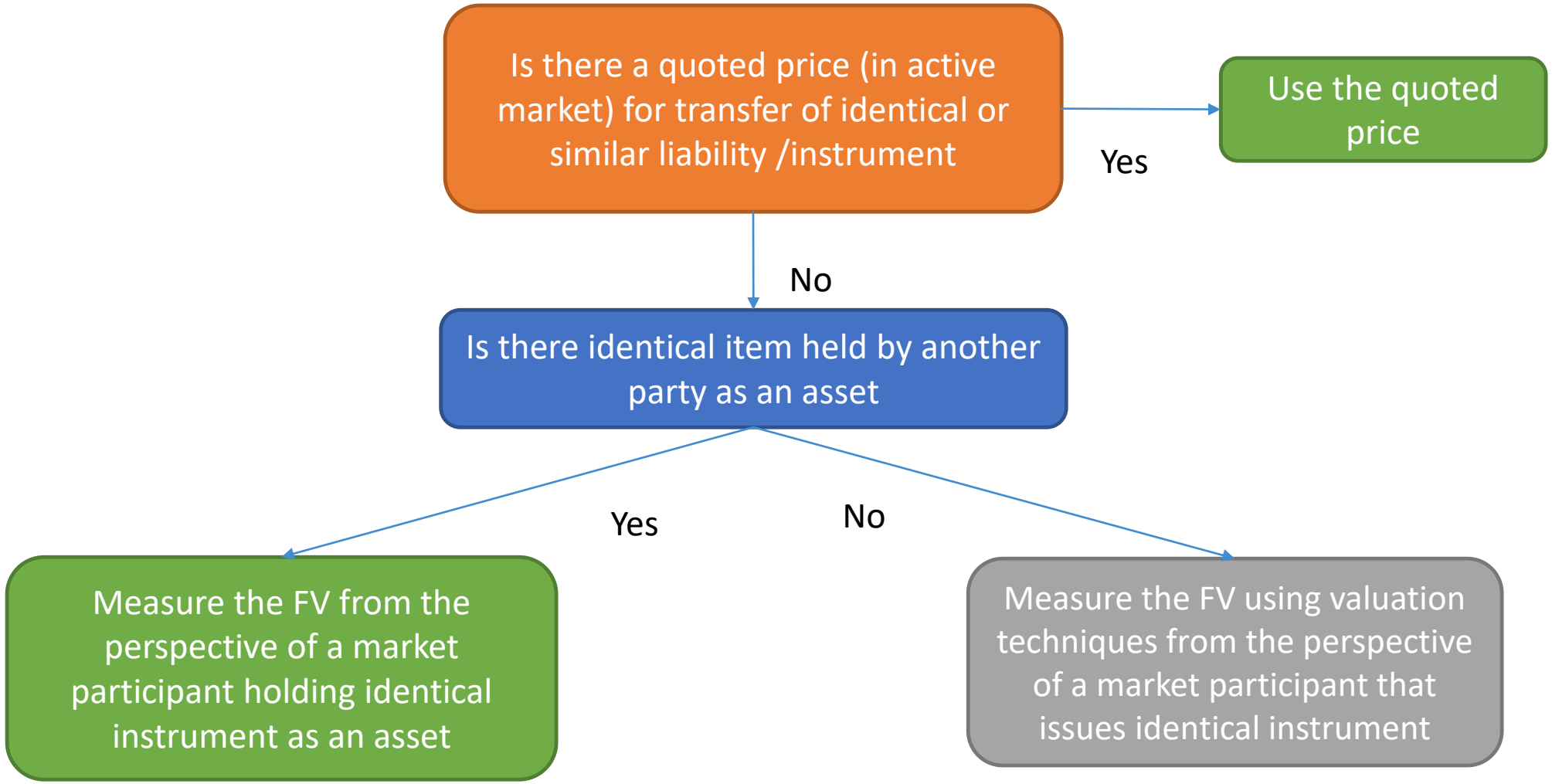
- Own Equity Instrument

FV is the price that would be paid to transfer the equity instruments

Assumptions

- The entity's own equity instruments would remain outstanding at the measurement date
- Market participant transferee would take on the rights and responsibilities associated with the instrument
- The instrument would not be cancelled or otherwise extinguished

FAIR VALUE OF LIABILITIES AND ENTITY'S OWN EQUITY INSTRUMENT



APPLICATION OF FAIR VALUE MEASUREMENT TO NON-FINANCIAL ASSETS

- Non Financial Assets:
  - An asset with physical value, such as real estate, equipment, machinery, or a vehicle.
  - These assets do not have any contractual claims like financial assets.

- Fair Value:

  A fair value measurement of a non-financial asset should take into account a market participant's ability to generate economic benefits

  - by using the asset in its **highest and best use**

    or

  - selling the asset to a market participant that would use the asset in its **highest and best use**.

APPLICATION OF FAIR VALUE MEASUREMENT TO NON-FINANCIAL ASSETS

- Highest and best use:

  The highest and best use of an asset might provide maximum value through either:-

  - Its use in combination with other assets and liabilities;

    or

  - On a standalone basis

Provided

- Physically possible *(location or size of the asset)*
- Legally permissible *(legal restrictions on the use of the asset)*
- Financially feasible *(ability to generate adequate income or cash flows to produce an investment return that market participants expect)*

APPLICATION OF FAIR VALUE MEASUREMENT TO NON-FINANCIAL ASSETS

- **Highest and best use**:
  - Entity's current use is presumed to be the highest and best use (unless market or other factors suggest a different use by market participants would maximise the value)
  - An entity not required to perform an exhaustive search for other potential uses if there is no evidence to suggest that current use is not the best use

APPLICATION OF FAIR VALUE MEASUREMENT TO NON-FINANCIAL ASSETS

Illustration:

Co. A owns a factory property comprising of freehold land and building which are accounted for in books as different elements and no depreciation on the land is claimed.

Co. A accounts for the factory property using revaluation model in accordance with Ind AS 16.

Taking into account all available market and other factors, Co. A determines that the highest and best use of the property is to develop a high rise commercial building looking at redevelopment of nearby sites for high rise commercial building

Question:

How should Co. A determine the FV of the property?

APPLICATION OF FAIR VALUE MEASUREMENT TO NON-FINANCIAL ASSETS

Answer:

The FV of the property should be determined on the assumption that Co. A would dispose the factory building to market participants at the measurement date and such market participants would demolish the factory building and use the site to develop a high rise commercial building.

VALUATION TECHNIQUES

VALUATION TECHNIQUES

- Three widely use valuation techniques;
  - Market Approach;
  - Cost Approach; and
  - Income Approach
- Single valuation technique appropriate when valuing asset using quoted prices in an active market for identical assets
- In other cases, multiple valuation techniques appropriate (for e.g. in case of valuation of CGU)
- If multiple valuation techniques used, results to be evaluated considering the range of values indicated by those results

MARKET APPROACH

- The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets, liabilities or a group of assets and liabilities, such as a business.
- This would include valuation techniques consistent with the market approach such as
  - market multiples (based on Revenue, EBITDA, etc.) derived from set of comparables
    - The section of the appropriate multiple within the range requires judgement, considering qualitative and quantitative factors specific to the measurement
  - Matrix pricing used generally for debt securities

COST APPROACH

- The cost approach reflects the amount that would be required currently to replace the service capacity of an asset; often referred to as current replacement cost
- From the perspective of a market participant seller, the price that would be received for the asset is based on the cost to a market participant buyer to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence
- Obsolescence encompasses:
  - Physical deterioration
  - Functional (technological) obsolescence
  - Economic (external) obsolescence
- The cost approach is typically used to measure the FV of tangible assets, such as plant or equipment

INCOME APPROACH

- The income approach converts future amounts (e.g. cash flows or income and expenses) to a single current (i.e. discounted) amount
- When the income approach is used, the FV measurement reflects current market expectations about those future amounts
- The income approach includes valuation techniques such as:
  - Present value techniques;
  - Option pricing models, such as the Black-Scholes-Merton formula or a binomial model; and
  - the multi-period excess earnings method, used to measure the fair value of certain intangible assets

PRESENT VALUE TECHNIQUES

- Capture all of the following elements from the market participants' perspective:
  - an estimate of future cash flows
  - expectations about possible variations in the amount and timing of the cash flows representing the uncertainty inherent in the cash flows
  - the time value of money, (i.e. a risk-free interest rate)
  - the price for bearing the uncertainty inherent in the cash flows (i.e. a risk premium)
  - other factors that market participants would take into account in the circumstances
  - for a liability, the non-performance risk relating to that liability, including the entity's own credit risk

PRESENT VALUE TECHNIQUES

- General principles governing the application of present value techniques:
  - Cash flows and discount rates should reflect assumptions that market participants would use when pricing the asset or liability
  - Cash flows and discount rates should take into account only the factors attributable to the concerned asset or liability
  - To avoid double-counting or omitting the effects or risk factors, discount rates should reflect the assumptions that are consistent with those inherent with the cash flows
  - Assumptions about cash flows and discount rates should be internally consistent
  - Discount rates should be consistent with the underlying economic factors of the currency in which the cash flows are denominated

VALUATION TECHNIQUES

Illustrative:

- Co. X has a 15% equity interest in Co. Y
- Co. Y's shares are not traded in an active market
- However, Co. Y is considered comparable to a number of companies whose shares are traded in an active market

Question:

- Which valuation technique(s) should Co. X use in estimating the FV of the equity interest in Co. Y ?

VALUATION TECHNIQUES

Answer:

- Cost approach is generally not appropriate in estimating the FV of investment in equity securities
- Market approach and income approach are common valuation techniques in estimating the FVs of investments in equity securities that are not publicly traded
- Not necessarily required to use both market approach and income approach – depends on the specific facts and circumstances
- For example: Where no significant adjustments are required regarding the market approach, it would be acceptable to use only the market approach in estimating the FV of the investment in equity securities.

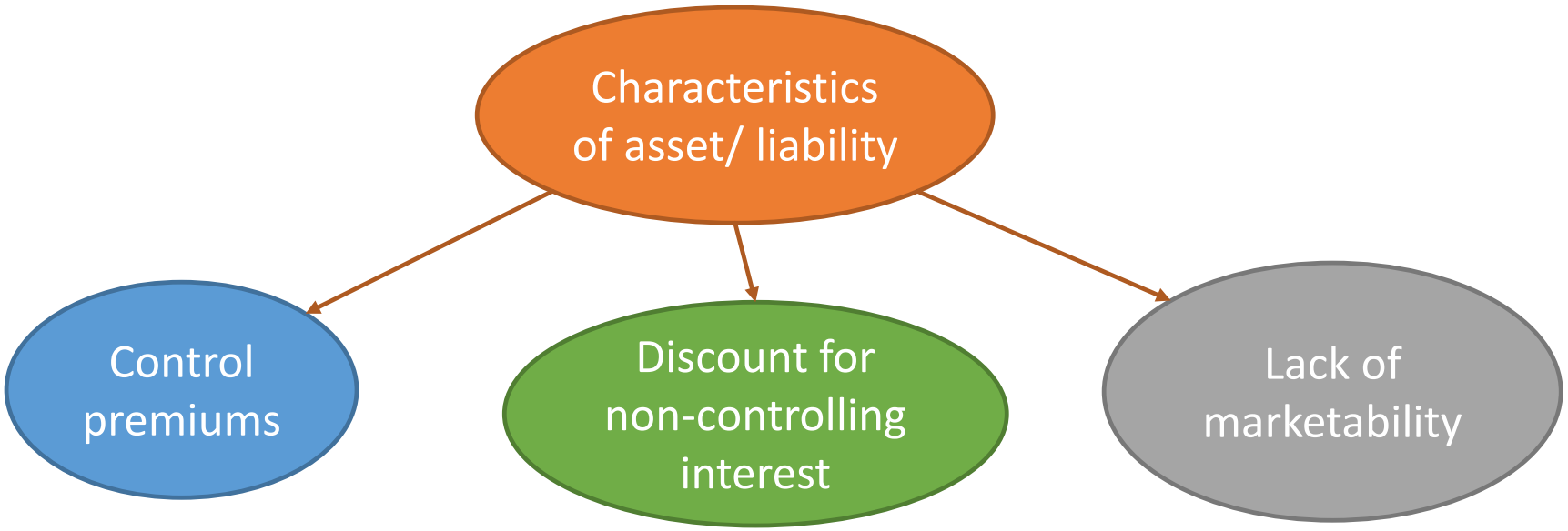
VALUATION TECHNIQUES

- No Rules as to which valuation techniques(s) must be used
- Select the most appropriate technique in circumstances, for which sufficient data is available
- Apply consistently
- Change in technique = change in accounting estimate (IND AS 8)

- Maximise the use of relevant observable inputs
- Minimise the use of unobservable inputs
- Select inputs that are consistent with characteristics of assets or liability (from market participant perspective)
- Consider factors like location and condition / restrictions on sale or use

VALUATION TECHNIQUES

- Characteristics of the asset or liability that market participant would take into account in a transaction

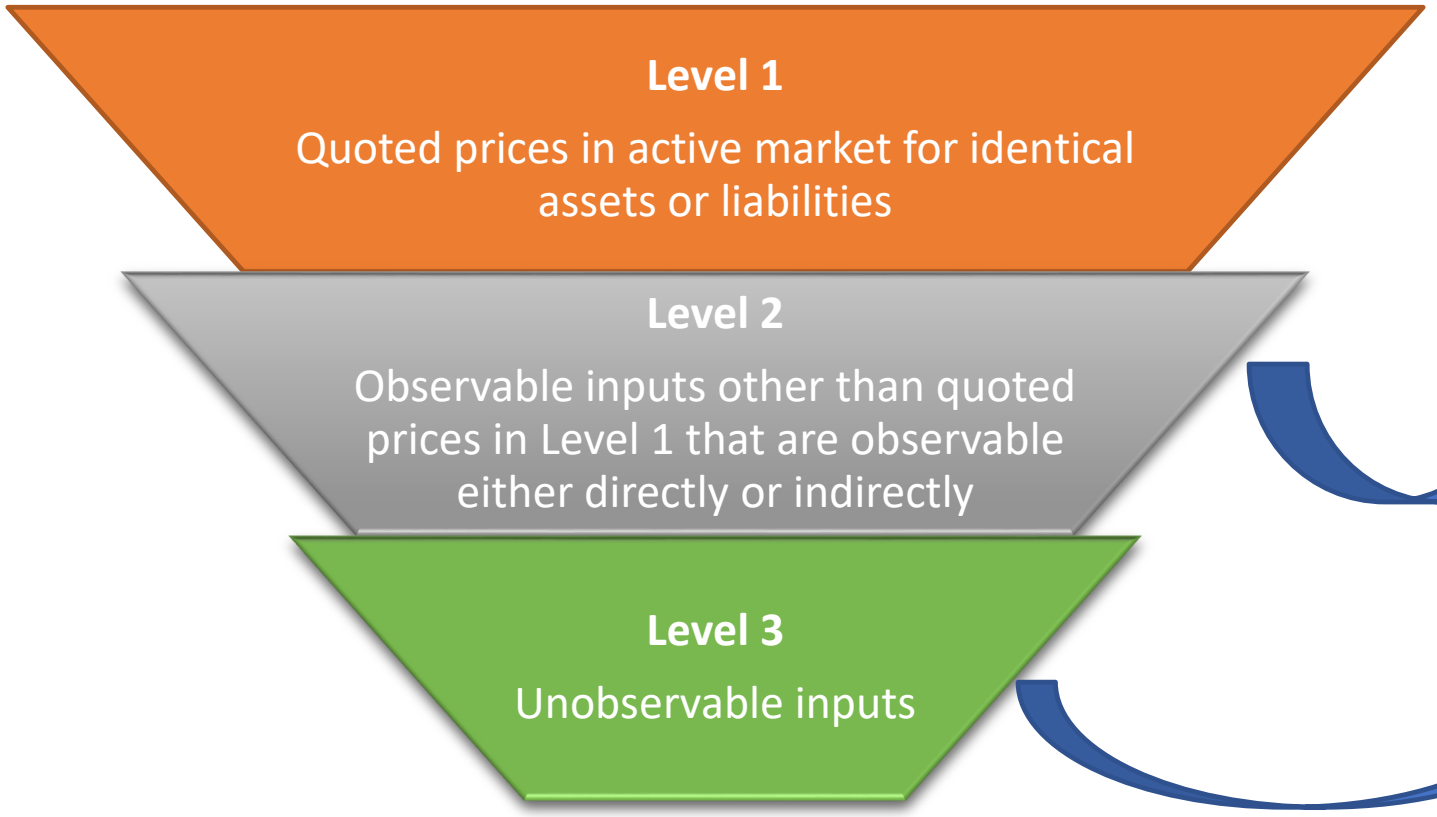


VALUATION TECHNIQUES

	Blockage factor (or block discount)	Control Premium	Discount for lack of marketability
Can fair value be adjusted for the premium or discount?	No	Yes, in certain circumstances.	Yes, in certain circumstances.
In what situations would these arise?	When an entity sells a large holding of the Company which exceeds the normal daily trading volume. Ind AS 113 does not permit to use block discounts.	When entity transacts for a controlling interest in the Company. (Unit of account is deemed to be the controlling interest)	When an asset or liability is not readily marketable. (No established market of readily available buyers and sellers)

FAIR VALUE HEIRARCHY AND INPUTS

FAIR VALUE HIERARCHY



- Developed using market data, such as publicly available information about actual events or transactions, and
- Reflect the assumptions that market participants would use when pricing the asset or liability

- Market data are not available and
- Developed using the best information available about the assumptions that market participants would use when pricing the asset or liability

OBSERVABLE V/S UNOBSERVABLE INPUTS

Observable

Publicly available information about actual transactions

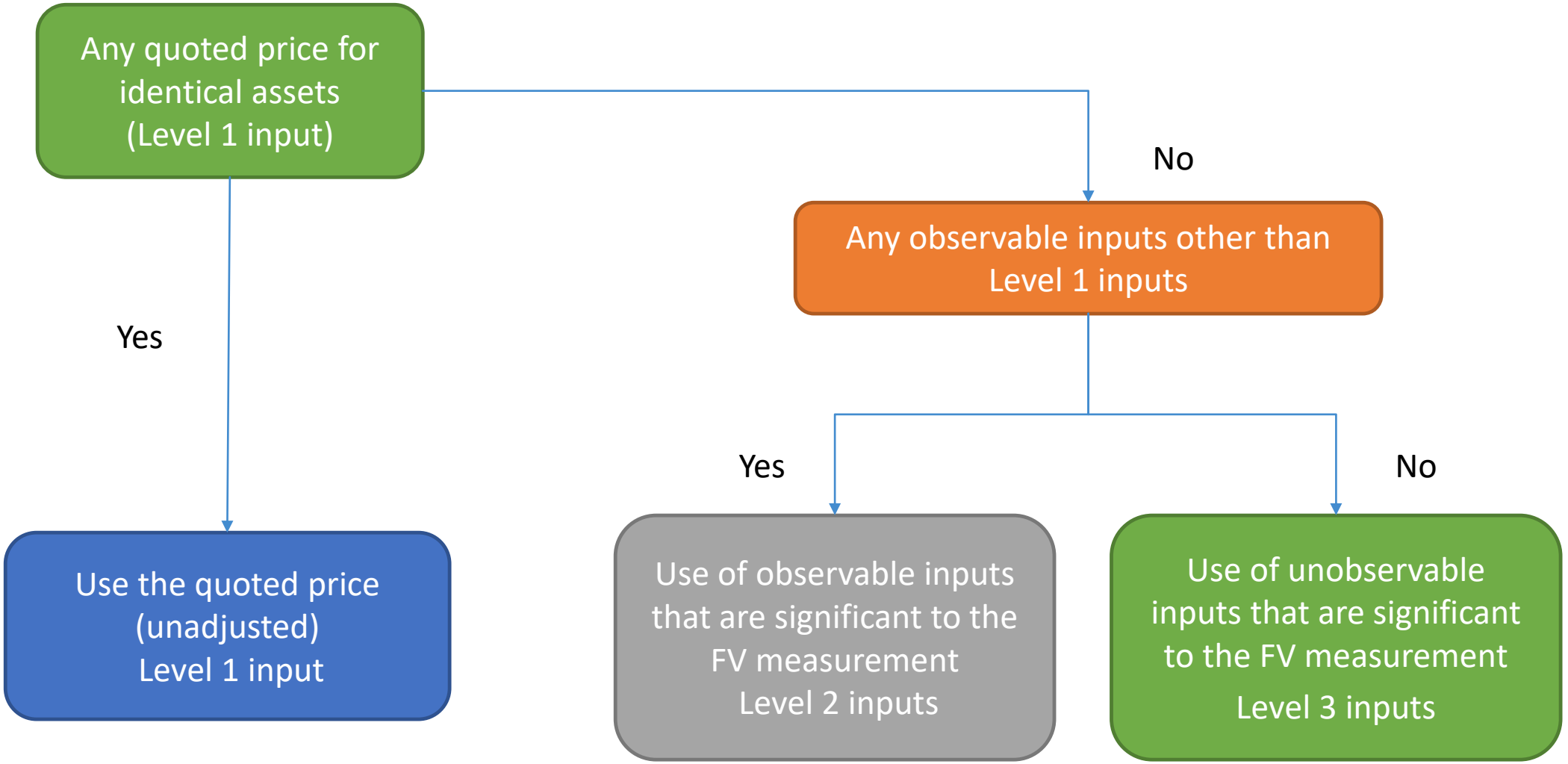
- Securities traded on stock exchanges.
- Prices for identical or similar assets in markets that are not active (for example, market data for sales of comparable land and buildings).
- Quoted prices of future contracts available on commodities exchanges.
- Available market data for rentals of properties.
- Example of markets for observable inputs: Exchange markets, dealer markets, brokered markets

Unobservable

Management assumptions cannot be corroborated with observable market data

- Management cash flow projections
- Adjustments to current prices for similar properties (for example, physical conditions and location)
- Estimates of growth expectations and profitability

FAIR VALUE HIERARCHY



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
  - Active Market: A market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis
- The quoted price should be used without adjustments except
  - When the reporting entity holds large number of similar assets and liabilities (not identical) whose quoted price are available but not easily accessible individually (e.g. debt securities)
  - When quoted price do not represent FV at the measurement date (e.g. significant event takes place after the close of market but before the measurement date)
- E.g. Financial instruments (for example, shares, exchange traded options and future contracts) traded on active markets.

LEVEL 2 INPUTS

- 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 are observable for the assets and liabilities (e.g. interest rates & yield curves, implied volatility, credit spread)
- Market corroborated inputs (e.g., prices derived from observed transactions involving comparable buildings in similar locations)
- Adjustments to these inputs will depend on :-
  - Condition or location of assets
  - The extent to which inputs relate to items that are comparable
  - The volume and level of activity in the market

IDENTICAL V/S SIMILAR ASSETS

- **Identical assets**:

Co. A bought equity shares of Co. B trading on National Stock Exchange ('NSE') . At the closing date, Co. A obtains available price published by NSE. Such price meets the definition of a Level 1.

- **Similar assets**:

Co. A owns a property located in Area X. At the reporting date, Co. A obtains information on price per square metre, derived from observed transactions of comparable properties in same area. The comparable properties are similar assets, but not identical and therefore the price would be a Level 2 input.

LEVEL 3 INPUTS

- Used only when observable inputs are not available (e.g., management's cash flow projections)
- FV measurement objective remains the same i.e.an exit price from the perspective of market participant
- Should reflect the assumptions that market participants would use for pricing including assumptions for risk
  - Both the risk inherent in a particular valuation technique and risk inherent to inputs should be considered
- Develop inputs using the best information available which would include the entity's own data
  - Adjust if information indicates that other market participants would use different data or something particular to the entity is not available to other market participants (e.g. entity-specific synergy)

FAIR VALUE HIERARCHY

- In some cases, inputs used to measure FV of an asset might be categorized within different levels of the FV hierarchy
  - Categorized in the same level of FV hierarchy as the lowest level input that is significant to the entire measurement
  - Assessing the significance of a particular input to the entire measurement requires judgement, taking into account factors specific to the asset
- Availability of inputs and their relative subjectivity may affect the selection of valuation techniques
- FV hierarchy prioritizes only the inputs to valuation techniques, not the valuation techniques
  - E.g. FV measurement using DCF method may be categorized as Level 2 or Level 3 depending on the inputs that are significant to the entire measurement
- If an observable input requires an adjustment using an unobservable input and that adjustment results in a significantly higher or lower FV measurement, the resulting measurement would be categorized within Level 3 of the FV hierarchy

FAIR VALUE HIERARCHY - ILLUSTRATION

- An entity is applying the income approach to estimate the fair value of an investment in equity shares of an unlisted company.
- Management estimates the terminal value based on long-term sustainable growth rates ranging from 2% to 4%. Growth rates are applied in order to extrapolate cash flow projections.
- Management's assumption is supported by the expected relevant average industry growth rate, which is based on observable market data.
- The growth rate meets the definition of a Level 2 input, as it can be corroborated by observable market data.

Question:

Whether the FV measurement would be categorised as a Level 2 or Level 3 of the fair value hierarchy?

Answer:

The expected future cash flows are one of the most significant inputs to the valuation technique. These are unobservable inputs and meet the definition of a Level 3 input. Therefore, the whole FV measurement will often be categorised within Level 3 of the FV hierarchy.

DISCLOSURES

DISCLOSURES

- Disclosure are based on whether the FV measurement are recurring or non-recurring
- **Recurring**: Other Ind AS permits or requires to measure FV on each reporting date
- **Non-recurring**: Other Ind AS requires fair value measurement only in particular circumstances
  - e.g. measuring assets held for sale = FV(-)Cost to sell

DISCLOSURES

Disclosure Requirement	Recurring FV Measurement	Non recurring FV Measurement
FV at reporting date	✓	✓
Reason for fair value measurement	X	✓
FV hierarchy level i.e. level 1,2,3	✓	✓
Transfer between Level 1 and 2 (including reason and entity's policy for transfer)	✓	X
Valuation technique, inputs, changes and reason for changes for Level 2 and 3 FV measurement	✓	✓
Level 3 - Valuation process / Policies	✓	✓

DISCLOSURES

Disclosure Requirement	Recurring FV Measurement	Non recurring FV Measurement
Level 3 - Unobservable inputs	✓	✓
Level 3 - Reconciliation total gain or loss in P&L and OCI, purchase, sales, issue, settlement, and transfer	✓	X
Level 3 - Unrealized gain / losses recognized in P&L	✓	X
Level 3 - Sensitivity of FV to changes in unobservable inputs	✓	X
Highest and Best Use of a non-financial asset (if different from current use) and why such asset is being used in a manner that differs from its Highest and Best Use	✓	✓

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THANK YOU !