Appraisal of the Blow of IND AS 113 Fair Value Elements on Financial Statements - A study

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Abstract

'Fair value is always market based measurement. It is not entity based measurement or entity specific measurement'.

Fair value is the chant of today in financial reporting crossways boundaries. In India also, the Institute of Chartered Accountants of India (ICAI) converged its accounting standards with IFRSs and accordingly, corporate financial statements beginning accounting year 2016-17 stated disclosing financial figures based on fair value measurement. One of the purposes of fair value measurement is to narrow the gap between balance sheet value and market value of a company. This paper reviews fair value accounting method relative to historical cost accounting. Even though both methods are broadly used by business concerns in calculating their income and financial positions, there is disagreement over dominance. Historical cost accounting reports assets and liabilities at the original price they were exchanged for at the time of the deal. on the other hand, fair value accounting quotes the current price in the market. yet, while both methods of accounting affect financial statements, the impact of fair value accounting on the balance sheet and income statement is tremendous due to the latent instability of the method.

Introduction

Indian Accounting Standard 113 (Ind. AS 113) helps companies with a unified practice to define the fair value of assets while declaring their financing statements. Ind AS 113 prescribes all types of assets and liabilities but does not prescribe i) which assets and liabilities to be fair valued and ii) whether to consider units individual or consolidated. The standard, apart from setting a single framework for measuring fair value, also prescribes the methods of disclosures of fair value measurements. Fair value measurement assumes that a transaction takes place in the principal market (i.e. the market with the greatest volume and level of activity) for the asset or liability or, in the absence of a principal market, in the most advantageous market for the asset or liability. [1]

Definition[2]

Fair Value	Comments
The price that would be received to:-	
Sell an Asset →	It refers to the selling of the asset
Paid to transfer a liability →	It refers to the transfer of liability
In an orderly transaction →	It is not a forced or distressed sale
Between market participants →	It is clear it is market-based (not Entity based)
At the measurement date → takes place	It states explicitly when the sale or transfer

"Accounting provides investors with a language and tools to make their own forecasts of future earnings growth," Lee says. "Most of the fair value stuff isn't going to help them. In fact, it's going to screw them up." [3]

General Definition 'In accounting and economics, fair value is a rational and unbiased estimate of the potential market price of a good, service, or asset. It takes into account such objective factors as: acquisition/production/distribution costs, replacement costs, or costs of close substitutes.'

Objective of Ind. AS 113

1. To determine FV.
2. To set out a single Ind. AS framework for measuring FV.
3. To require disclosures with respect to FV measurements.

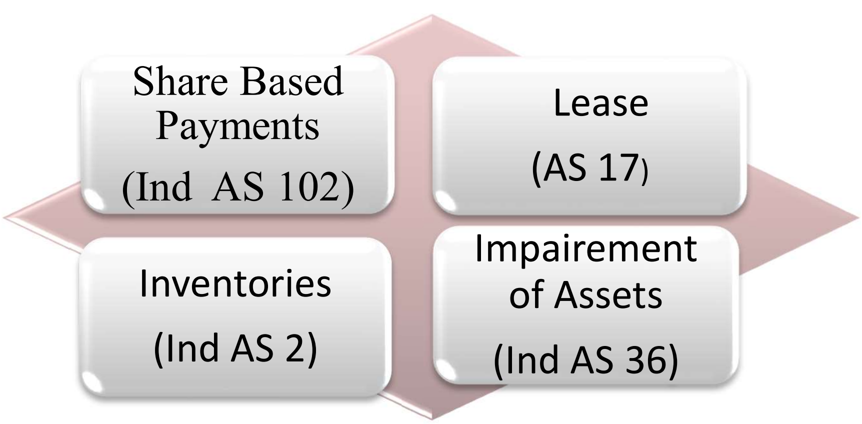
Standards/Transactions requiring FVM

Followings standards/ Transactions are required fair value measurements:

1. Business combinations (Ind AS 103)	15. Property, plant and equipment—

2. Assets acquired and liabilities assumed 3. Contingent consideration 4. Non-controlling interests in an acquire 5. Previously held interest 6. Financial instruments: Recognition and measurement (Ind. AS 39) 7. Assets/liabilities eligible for FV option 8. Derivatives 9. Hybrid financial instruments 10. Financial guarantee contracts 11. Debt and equity investments 12. Employee benefits— post-employment benefit obligations (Ind. 6 AS 9) 13. Intangible assets— revaluation model (Ind. AS 38) 14. Investments in associates and joint ventures—held by mutual funds and similar entities (Ind. AS 28)	revaluation model and exchange of assets (Ind. AS 16) 16. Noncurrent assets held for sale and discontinued operations (Ind. AS 105) 17. Investment property (Ind. AS 40) 18. Agriculture—biological assets (Ind. AS 41) 19. Impairment of assets— nonfinancial assets (Ind. AS 36) 20. Revenue (Ind. AS 18) 21. Consolidated and Separate Financial Statements—investments in subsidiaries by investment entities (Ind. AS 27) 22. Government Grants – non-monetary government.

Ind. AS 113 does not apply to the following:



FV 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

Orderly Transaction

A transaction that assumes:

a. Exposure to the market for a period before the measurement date to allow for marketing activities;
b. That is usual and customary for transactions involving such assets or liabilities;
c. It is not a forced transaction (eg a forced liquidation or distress sale).

Market Participants

Buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics: **[WIKA]**

- ❖ They are **willing** to enter into a transaction for the asset or liability, ie they are motivated but not forced
- ❖ They are **independent** of each other, i.e they are not related parties as defined in Ind. AS
- ❖ They are **knowledgeable**, having a reasonable understanding about the asset or liability
- ❖ They are **able** to enter into a transaction for the asset or liability

FV Valuation Techniques

No particular technique mandated by Ind. AS 113. �Valuation technique entity uses must maximize the use of relevant observable inputs and minimize the use of unobservable inputs:

Figure -1

The Market Approach	.is based on market transactions involving identical or similar assets or liabilities. There Are two types of market for any assets or liability **Principal Market (PM)** | **Most Advantageous Market (MAM)**
The Cost Approach	is based on the amount required to replace the service capacity of an assets (frequently referred to as current replacement cost.)
The Income Approach	is based on future amounts that are converted (discounted) to a single present amount.

Sources; IFRS -13 par. B 5, B8, B10-11

Price for Fair Valuation

Preference -1	Preference -2
Price for fair valuation shall be based on principal market *i.e.* a market with highest level of activity	Price for fair valuation shall be taken from most advantageous market *i.e.* a market where realization is highest.

Figure -2

- ✓ Transaction cost is not uniform hence not adjusted in fair value.

- ✓ Transportation cost is uniform hence adjusted in fair value.

Transaction Value is Equal to Fair Value except[15]

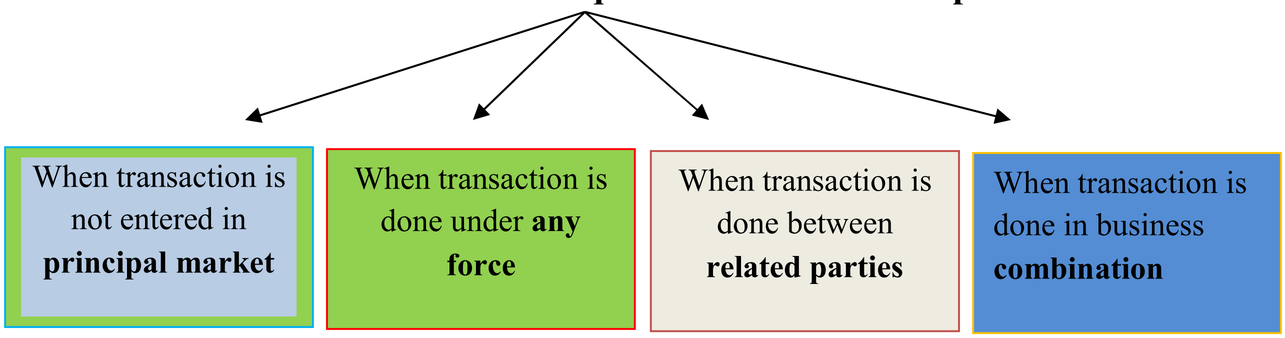


Figure -3[15]

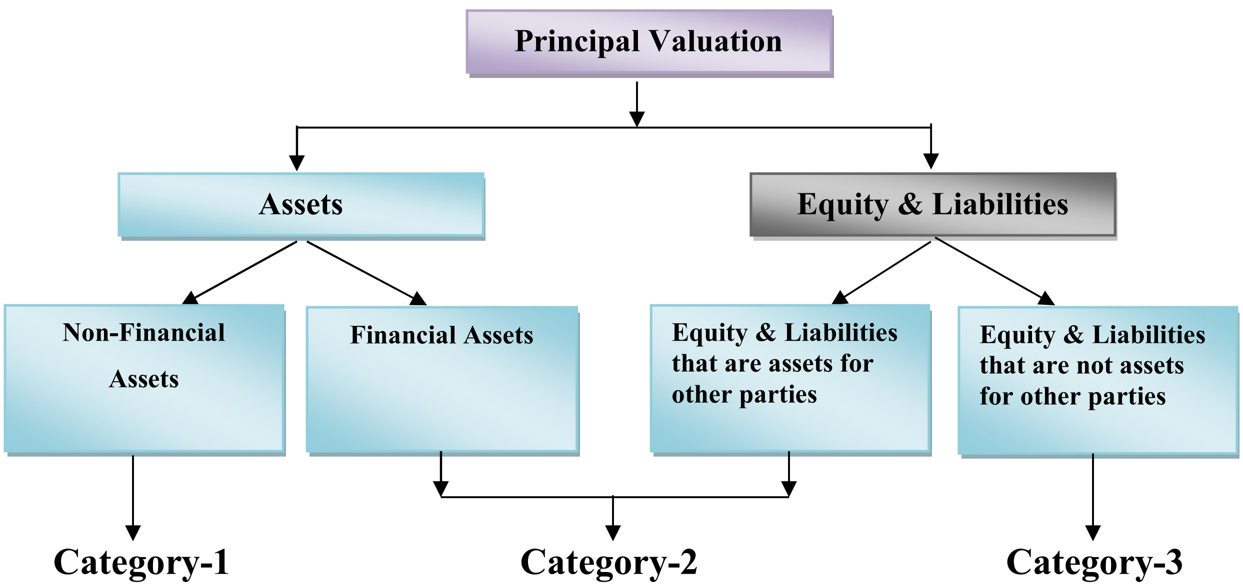


Figure -4

Non-Financial Assets (Category-1) [15]

Non- Financial assets are assets without contract. Non- financial assets shall be valued on the basis of highest and best use principle.

Highest and best use principle considers:

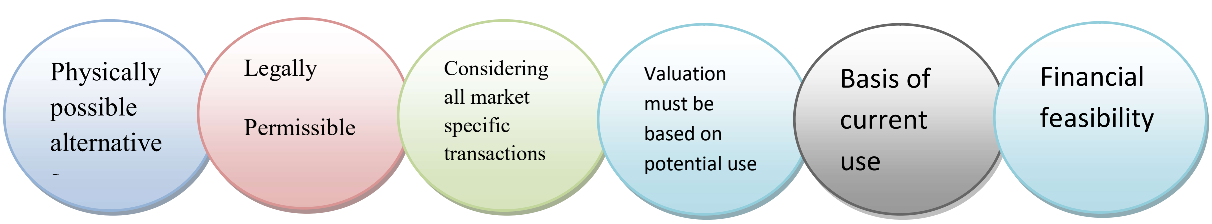


Figure-5

Financial Assets (Category-2) [15]

Financial assets are assets with contract. Financial assets are either equity or liability for other entity.

Grading of fair value[15]:

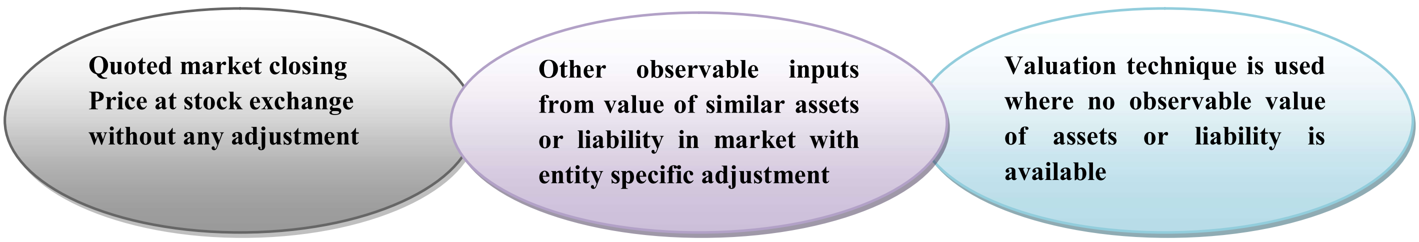


Figure-6

Equity & Liabilities that are not assets for other parties (Category-3) [15]:

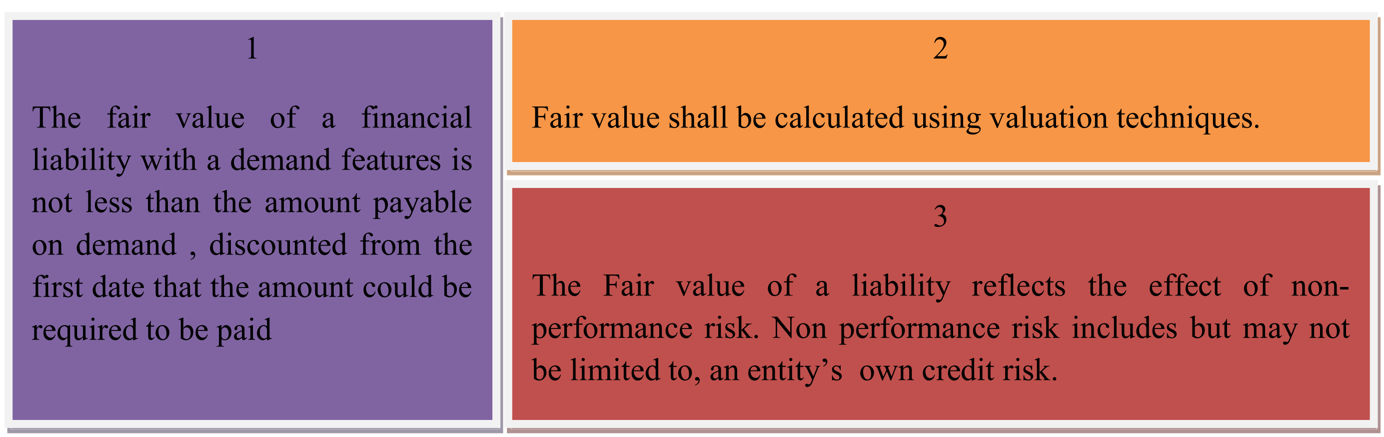
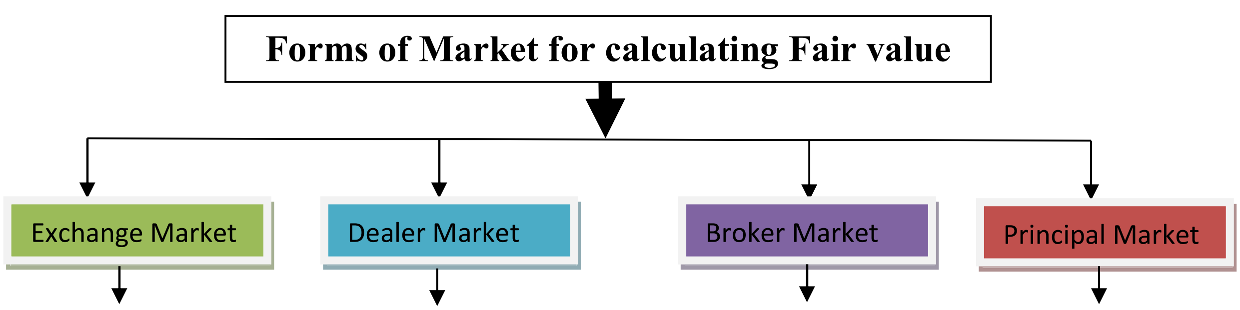


Figure-7



This is the most efficient /strong market. Value is considered without any adjustment.

Dealer means an entity which is ready to buy/sell assets at any time at given price. But this is not pure price and hence adjustment is needed

Where broker is aware of the perfect match between buyer and seller. Price is not pure and hence adjustment is required.

Here buyer and seller are independent. Price is subject to negotiation.

Figure-8

General Industry Practice of Fair Valuation[15]

S. No.	Assets/ Liabilities	Level-1	Level-2	Level-3
1.	Property /Plant and Equipment	-	Replacement price	Discounted Cash flow
2.	Capital WIP	-	-	Discounted Cash flow or Cost approach
3.	Investment property	-	Replacement price	Discounted Cash flow or rent Capitalization
4.	Biological assets	-	Market value	Discounted Cash flow
5.	Loan given (Assets)	-	-	Discounted Cash flow
6.	Debtors or Bills receivable	-	-	Original Invoice
7.	Investment in equity shares or debentures (Assets)	Quoted Price on stock exchange	Price of similar assets after adjustment	Dividend/ Interest/ Earning Capitalization
8.	Loan Liability	-	-	Discounted Cash flow
9.	Equity Shares and debentures Issued (Equity or Liability)	Quoted Price on stock exchange	Price of similar assets after adjustment	Dividend payable/ Interest payable/ capitalization
10.	Creditors or Bill Payable	-	-	Original Invoice

Conclusions;

- Ind. 116 provides guidelines for basic valuation of assets and liabilities separately, rather than on net basis.
- However there are situations where net valuation is permitted. For example- Fair valuation of derivative which are being netted with all exciting open position can be made on net basis.
- Valuation Base:
    - i. Assets Base, if Assets > Liability
    - ii. Liability Base, if Liability > Assets.
- Rules applicable in case of Net Valuation:
    - i. Other participants also manage similar risk on Net Basis.
    - ii. There should be same information and market practice available for making these assets liabilities on Net basis.

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