Convergence to Ind AS and Fair Value Measurements

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Discussion points

- ✓ **Applicability of fair value measurement principles**

- ✓ **Certain key definitions**
- ▪ Fair value
- ▪ Orderly market transaction – observable inputs , unobservable inputs, primary market
- ▪ Market participants

- ✓ **Key aspects of fair value measurements**

- ✓ **The fair value measurement criteria -**

- ✓ **The recognition of fair value measurement**

- ✓ **Fair value hierarchy**

- ✓ **Some common instances of fair value measurements in Ind AS financial statements**

Applicability of fair value measurement principles

Application of Fair value measurements

- ✓ **Applies to measurements and disclosures about measurements that are based on *fair values***

- ✓ **Applies to fair value measurements** both at initial recognition of an asset or a liability or to their subsequent measurement ***[Para 8]***

- ✓ **Covers all financial / non financial assets and liabilities which are measured at fair value *except the following:***
  - Share based payment transactions (Ind AS 102);
  - Leasing transactions (Ind AS 17)
  - Value in use under Ind AS 36 / net realisable value under Ind AS 2 – which are similar to fair value but are not fair value *(exemption from disclosure requirements)*

- ✓ Applies to *stand alone asset or liability* or *group of assets or liabilities or a combination thereof (viz a cash generating unit)*

- ✓ Also covers an entity's own equity instruments that are required to be measured at fair value

The key aspects of fair value measurement

Key aspects

- ✓ ***Fair value is*** market based measurement (*not an entity specific value)* [Para 2];

- ✓ Fair value should reflect the current market conditions using assumptions that market participants would use;

- ✓ *A*n entity's intention to hold an asset or settle a liability is not relevant to measuring fair value [Para 3]

- ✓ Ability to access market is sufficient to determine fair value, *ability to sell asset or transfer liability at measurement date is not relevant* to determine fair value [Para 20]

- ✓ Fair value based on transactions, carried on an *either in* the principal market for the asset or liability or in the most advantageous market (in the absence of principal market) [Para 16]

- ✓ In the absence of *an observable market* for determining a price, fair value measurement shall be based on the assumption that a transaction takes place at measurement date *considered from the perspective of a market participant that holds the asset or owes the liability* ***[Para 21]***

Key aspects

- ✓ In case of a *non financial asset,* price (fair value) is based on '*highest and best use' method* – this method not available for financial assets, financial liabilities or own equity instruments as these do not have an alternative use

- ✓ Quoted price in an active market for identical assets and liabilities is best evidence of a fair value

- ✓ In the absence of any observable price for an identical asset/ liability, fair value is measured using other valuation techniques that **maximises** the use of *relevant observable data* and **minimises** the use of *unobservable inputs [Para 3]*

- ✓ Inputs used to determine fair values are categorised into Level 1, Level 2 and Level 3 categories generally referred to as a *Fair Value hierarchy*

What is fair value

Meaning

- ✓ **Fair Value: is the**
- Price
- That would be received to sell an asset or paid to transfer a liability;
- In an orderly market;
- Between market participants;
- At the Measurement date

- ✓ **The principal components of fair value measurement:**

1. Price
2. **Markets**
3. **Market participants**

1. The PRICE

- ✓ **Fair Value: is the**
- Amount to be received from sale of an asset or paid to transfer a liability
- In an orderly market transaction

- ✓ **Price:** *is determined either*
- ***Directly observable*** – based on quoted prices in an active market for identical asset or liability; or
- ***Estimated*** – using another valuation technique

2. The Market

- ✓ **Orderly markets: wherein the transactions** represents marketing activities that are usual or customary for transactions involving assets or liabilities under consideration, *it is not a forced transaction viz. forced liquidation or distress sale)*

- ✓ Markets selected for fair value measurements of an asset or liability should be
- *Principal market*; OR
- *Most advantageous market* (in the absence of a principal market)

- ✓ *No exhaustive searches required to identify principal or most advantageous markets* – market in which the entity normally enters into a transaction is considered as a principal (or most advantageous) market [Para 17]

- ✓ *If there is a principal market for a particular asset or liability,* fair value shall be the price prevalent therein *whether or not* price in a different market is more advantageous at measurement date [Para 18]

Definitions - Markets

- ✓ **Principal Market:** market with greatest volume of activity for the asset or liability

- ✓ **Most advantageous market:** market that maximises the amount that would be received to sell the asset or minimises the amount that would be paid to transfer the liability, after taking into account transaction costs and transport costs

- ✓ ***Active Market*:** market in which transactions for the asset or liability take place with *sufficient frequency and volume* to provide pricing information on an ongoing basis

3. Market Participants

- ✓ **Market Participants: are buyers and sellers** in the principal (or most advantageous) market for the asset or liability *having all following features*:
- ▪ They are not related parties as defined in Ind AS 24;
- ▪ They are knowledgeable (reasonable understanding of the asset or liability);
- ▪ They are able and willing to enter in the transaction for the asset or liability *(not forced or compelled to do so)*

- ✓ *An entity need not identify specific market participants in determining fair value for an asset or liability*

The Measurement criteria

Fair value Measurement

- ✓ ***Fair value measurement*** requirements apply equally when an item is measured at fair value at *initial recognition* as well as subsequent measurement in accordance with Other Ind ASs [Para 8]

- ✓ Fair value should reflect the current market conditions using assumptions that market participants would use *rather than* an entity's intention to hold an asset or settle a liability

- ✓ Valuation techniques should *maximum the use of relevant observable inputs* and *minimise the use of unobservable inputs* when obtaining data to measure fair value [Para 61]

- ✓ Quoted price in an active market for identical asset or liability is the best indicator of a fair value

- ✓ When measuring fair value, relevant market price should not be adjusted for *transaction costs*

Fair value Measurement

- ✓ Use of Other valuation techniques:
- ▪ In the absence of a price for an identical asset or liability,
- ▪ Such valuation techniques maximise the use of relevant *observable inputs* and minimise the use of *unobservable inputs*

- ✓ *Fair Valuation techniques include*
- ▪ Market approach – active market data
- ▪ Cost approach – current replacement cost
- ▪ Income approach - discounted cash flow approach

- ✓ **Consistency :** valuation techniques to measure shall be applied consistently *unless* a change in valuation technique is more representative of a fair value of the asset or liability in the circumstances [Para 65]

Observable v/s unobservable inputs

- ✓ **Observable inputs:** inputs that are developed using market data viz. publicly available information about actual events / transactions used in pricing the asset or liability
- such inputs are generally available in *exchange markets, dealer markets, brokered markets etc*

- ✓ **Unobservable inputs:** inputs for which market data are not available and are developed using best information available
- Such inputs may include entity's own data
- Adjustments is permitted if reasonably available information indicates that other market participants use different data or in case of

Fair value - Non financial assets - Highest and Best use method

- ✓ The method takes into account market participant's ability to generate economic benefits by using the asset; or by selling it to another market participant that would use the asset in its highest and best use

- ✓ The method takes into account the use of the asset that is *physically possible* (location / size of the asset), *legally permissible* (whether or not there are restrictions on the use of the asset) and *financially feasible* (availability of adequate income or cash flows from use of the asset)

- ✓ This method is from the perspective of market participants, *even if in reality it is intended for a different use by entity*

- ✓ ***The use of method presumes consistent sale of the non financial asset to determine fair value [Para 32]***

- ✓ ***Fair value is determined as follows***:
- ▪ If the non financial asset is used in combination of other assets and/or liabilities – fair value is the total value receivable in a current transaction to sell the assets and other associated liabilities in aggregate
- ▪ If the non financial asset is used on stand alone – fair value receivable in a current transaction to sell the asset on a stand alone basis

Fair value - Liability and own equity instruments

- ✓ Entity shall maximise the use of relevant observable inputs and minimise the use of unobservable inputs to arrive at the fair value at measurement date

- ✓ Where no observable market inputs are available for an identical or similar liability or entity's own equity instrument, the fair value shall be determined as:

- Fair value of the liability or equity instrument from the perspective of the holder of an identical item as an asset at measurement date – *either at quoted price in an active market or other valuation techniques*

- Where quoted price is neither available nor such identical liability or equity instruments is held by any other market participant – *fair value determined from the entity's perspective that has incurred the liability or has issued the equity instrument*
- ***[Para 38-40]***

Fair value - Liability and own equity instruments

- ✓ **Fair value of liability – includes non performance risk**
- Fair value measurement **includes** the effect of *non-performance risk*
- Non performance risk includes entity's own credit risk
- Risk of third party grantor not considered when measuring the fair value of the liability ***[Para 42-44]***

- ✓ **Restrictions preventing transfer of a liability or an entity's own equity instruments**
- Never included as a separate adjustment in the calculation of the fair value of liability or own equity instrument

- ✓ **Financial liability – includes demand feature (payable on demand)**
- Fair value *is not less than* the amount payable on demand
- Discounted from the first date that the amount could be required to be paid
- *Amounts receivable or payable on demand* – the fair value normally is equal to the transaction price at the measurement date [Para 47]

Fair value – Exchange transactions

- ✓ **Asset is acquired or liability assumed in an exchange transaction for that asset or liability**
- **The transaction price is :** price paid to acquire the asset or received to assume the liability *(an entry price)*

- **Fair value of the asset or liability:** price that would be received to sell the asset or paid to transfer the liability

- **The rationale:**
  - Entities do not sell assets at prices paid to acquire them &
  - Entities do not transfer liabilities at prices received to assume them

[Para 57]

The Recognition – Fair Value

Fair value Measurement – Initial recognition

- ✓ *Fair value* is the "***transaction price***" paid in a market transaction to acquire the asset or settle the liability

- ✓ In many cases the transaction price will always be equal to fair value

- ✓ ***Indicators that transaction price is not the fair value of the asset or liability at initial recognition:***

- ▪ The transaction is between related parties

- ▪ Transaction takes place under duress or the seller is forced to accept the price in the transaction

- ▪ Market in which the transaction takes place is different from the principal market (or most advantageous market)

Fair value Measurement – Initial recognition

✓ **Day 1 - P&L:**

- When at measurement date the transaction price is not equal to fair value;

- ***Difference is required to be recognised as gain or loss in P&L -*** is generally in case of fair value, evidenced by quoted price in an active market for an identical asset or liability OR, based on valuation technique that uses data only from observable markets

- In other cases (no observable market data) or when specifically required by other Ind ASs *day 1 loss or gain is deferred and accounted separately under the other standard.*

The Fair Value Hierarchy

Fair Value hierarchy – general points

- ✓ *I*nputs to the valuation techniques used to measure fair value are categorised as follows

- ✓ **Level 1 inputs**
- ▪ Are quoted prices (unadjusted) in an active market for identical assets or liabilities at measurement date;
- ▪ Such input should be used without adjustment to measure fair value

- ✓ **Level 2 inputs**
- ▪ Are inputs other than quoted prices within level 1
- ▪ Include
- \- Quoted prices for similar (not identical) assets or liabilities in active market
- \- Quoted prices for identical or similar assets or liabilities that are NOT active;
- \- Inputs other than quoted prices eg. Interest rates, yield curves

- ✓ **Level 3 inputs**
- ▪ Are unobservable inputs for the asset or liability

Application of fair value measurement principles

Common items in Ind AS financial statements requiring application of fair value measurements

- ✓ **Investments in equity or other instruments of entities other than subsidiary / associate or joint venture**
- ✓ **Unsecured loans to related parties at zero or below market rate of interest**
- ✓ **Loans to employees / security deposits given**
- ✓ **Issue of compound financial instruments – viz preference shares etc. issued by an entity having financial liability as well as equity components**
- ✓ **Financial guarantees provided by holding company on behalf of loans granted by banks / financial institutions to subsidiary companies and vice versa**
- ✓ **Non current assets classified as held for sale in accordance with Ind AS 105**
- ✓ **Government loans at zero or below market interest rates viz. Tax deferral liability etc.**