Ind AS 113
Fair valuation

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WIRC Intensive Study Course

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Accounting standards requirements

Accounting standard requirements

Ind AS 36 – Impairment of Assets

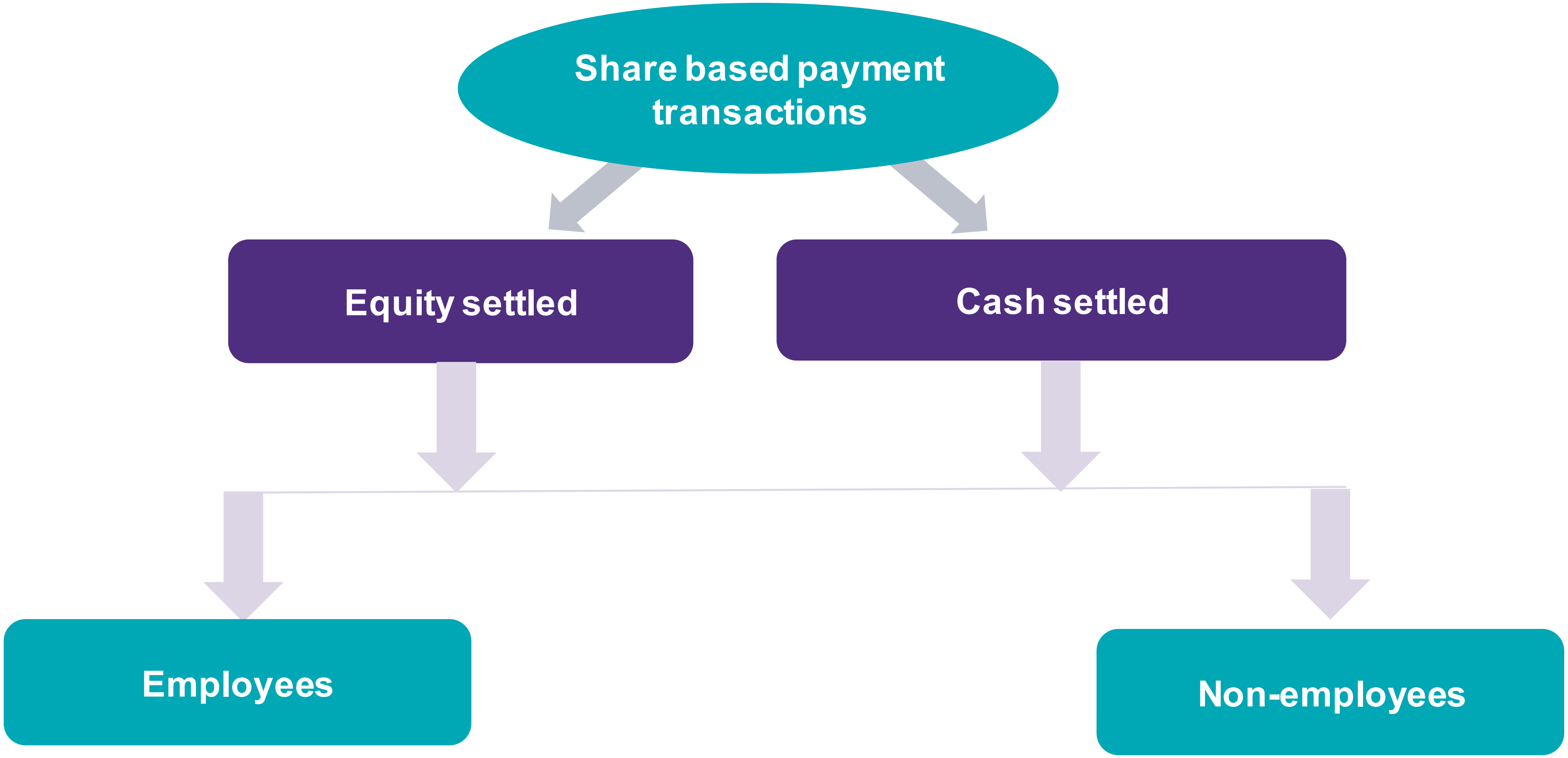
The **CARRYING AMOUNT** > The **RECOVERABLE AMOUNT** = Asset is **IMPAIRED**

Recoverable amount is higher of

- **Fair value less costs of disposal**
- **Value in use**

Accounting standard requirements

Ind AS 102 – Share Based Payments



Accounting standard requirements (cont'd)

Ind AS 103, Business Combinations

- step 1: identify a business combination
- step 2: identify the acquirer
- step 3: determine the acquisition date
- step 4: recognise/measure identifiable assets acquired/liabilities assumed
- step 5: recognise/measure any non-controlling interest
- step 6: determine the consideration transferred
- step 7: recognise/measure goodwill (or gain from a bargain purchase)

Accounting standard requirements (cont'd)

Ind AS 109, Financial Instruments

Financial Assets	Financial Liabilities
Amortized cost	Amortized cost
Fair value through OCI	
Fair value through P&L	Fair value through P&L

Accounting standard requirements (cont'd)

Ind AS 107, Financial Instruments, Disclosures

Disclosures in relation to Fair Value

- Fair value of each class of asset and liability
- Methods to arrive at fair value
- Valuation techniques and assumptions used to arrive at fair values
- For each class of financial instruments, disclosures include:
  - Level of fair value hierarchy into which fair value measurements are categorized
  - Significant transfers and reasons for such transfers between levels
  - Reconciliation of balances for fair value measurements at Level 3
  - Sensitivity analysis for Level 3 fair value measurements

Accounting standard requirements

Ind AS 16 – Property, plant and equipment and Ind AS 38 – Intangible assets

Initial measurement	COST (except for specific intangible assets)
Subsequent measurement	COST OR REVALUATION
Exchange of assets for no-monetary assets	Fair value, unless specific conditions not met

Accounting standard requirements

Ind AS 40 – Investment Property

Initial measurement →	**COST**
Subsequent measurement →	**COST, however, fair value to be disclosed**

Accounting standard requirements

Ind AS 105 – Non current assets held for sale and discontinued operations

Non current assets held for sale shall be measured at lower of

Carrying amount

AND

Fair value less costs to sell

Accounting standard requirements

Certain other areas where fair valuation has an impact

Ind AS 115	Measurement of non-cash consideration
Appendix C to Ind AS 17	Separation of lease and non-lease components from arrangements containing a lease
Appendix D to Ind AS 109	Fair valuation of equity instruments issued to extinguish all or part of a financial liability

Ind AS 113

Need for a standard on Fair Value?

Value to an Art Collector?

Value to a Scrap dealer?

Value depends on perspective

Need for a standard on Fair Value?

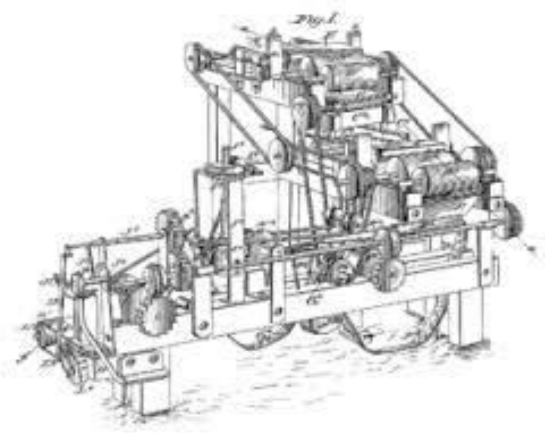
Can be sold in USA for USD 4-5 millions

Can be sold in India for USD 0.5-1 millions

Value depends on market in which asset is transacted

Need for a standard on Fair Value?

A standard machine is sold in the market for INR 10 lacs



Mr. ABC having this machine can generate a value of 1 crore by using a unique process only known to him

Assets "in-use" value is different than market value

Navigating Ind AS 113

Objective	defines **fair value,** sets out a single framework for its **measurement** and required **disclosures**
Scope	• All fair value based measurements and disclosures except: - leases (in the scope of Ind AS 17) - share-based payments (in the scope of Ind AS 102) - measurements that have some similarities to fair value but are not fair value, such as net realisable value in Ind AS 2 Inventories or value in use in Ind AS 36 Impairment of Assets. • Disclosures not applicable for: - plan assets measured at fair value per Ind AS 19 Employee Benefits - assets for which recoverable amount is fair value less costs of disposal in accordance with Ind AS 36.

Navigating Ind AS 113

Core principle	**Fair value** is a **market-based measurement**, not an entity-specific measurement and propagates **maximum use of relevant observable inputs** & minimum use of unobservable inputs. Does **not** attempt to **remove judgment** involved in estimating fair value and only provides a consistent framework to reduce inconsistency & increase comparability in fair value measurements.
Key definitions	• Fair value • Unit of account • Principal and most advantageous market • Market participants • Highest and best use

Definition of fair value and key determinants

Definition of fair value	**Fair value is defined as:** • the price that would be **received to sell** an asset or **paid to transfer** a liability (exit price) • in an **orderly transaction** • between **market participants** • at the **measurement date**.

Transaction

- Hypothetical & Orderly i.e. in Principal & Most Advantageous
- Between market participants

Price

- Selling Price
- Does not include transaction cost

Asset

- Characteristic of asset like-
  - Location
  - Restrictions to sale
  - Standalone versus group

Key determinants

Key determinants	
1	**Transaction – In the Principal and most advantageous market** Fair value measurement assumes 'the transaction to sell the asset or transfer the liability takes place either: (a) in the principal market for the asset or liability; or (b) in the absence of a principal market, in the most advantageous market for the asset or liability'.
2	**Transaction – Between Market participants and measurement date** An entity uses the **assumptions that market participants would use** when pricing an asset or liability at **measurement date.** Market participants have following characteristics: • Independent of each other • Knowledgeable, having a reasonable understanding • Able to enter into a transaction • Willing to enter into a transaction

Key determinants

Key determinants

3

Transaction - To Sell and transaction costs

As at the measurement date, the transaction to sell an asset or transfer a liability is, by definition, a **hypothetical transaction** for the particular asset or liability being measured at fair value in an orderly market.

Fair value is not adjusted for **transaction costs**, viz, the costs to sell an asset or transfer a liability in the principal (or most advantageous) market that are directly attributable to the disposal of asset or the transfer of liability.

4

Asset - Unit of account & Asset Characteristics

Item to be measured is based on unit of account specified by Ind AS that requires/permits fair value e.g. as a:

- stand-alone asset or liability (e.g. financial asset or liability) ; or
- group of assets or liabilities (e.g. cash generating unit) ; or
- group of assets and liabilities (e.g. business).

The **unit of account** is the **level** at which an **asset** or a **liability** is **aggregated** or **disaggregated** in an Ind AS for recognition purposes.

Key determinants

Company A has developed a high end software Alpha which it sells to it customers in India. Company A is acquired by Company B which also has a similar internally generated software and software Alpha would have been of no use for Company B. Though Company B acquired Company A primarily for its customer relationships, the software Alpha also came along with the acquisition.

What is the value ascribed by company B to the software asset?

Fair value hierarchy

Ind AS 113 establishes a **three level fair value hierarchy** for inputs to measure fair value:

unadjusted quoted prices in active markets for identical assets or liabilities

Level 1

inputs other than quoted prices included in Level 1 that are observable, either directly or indirectly

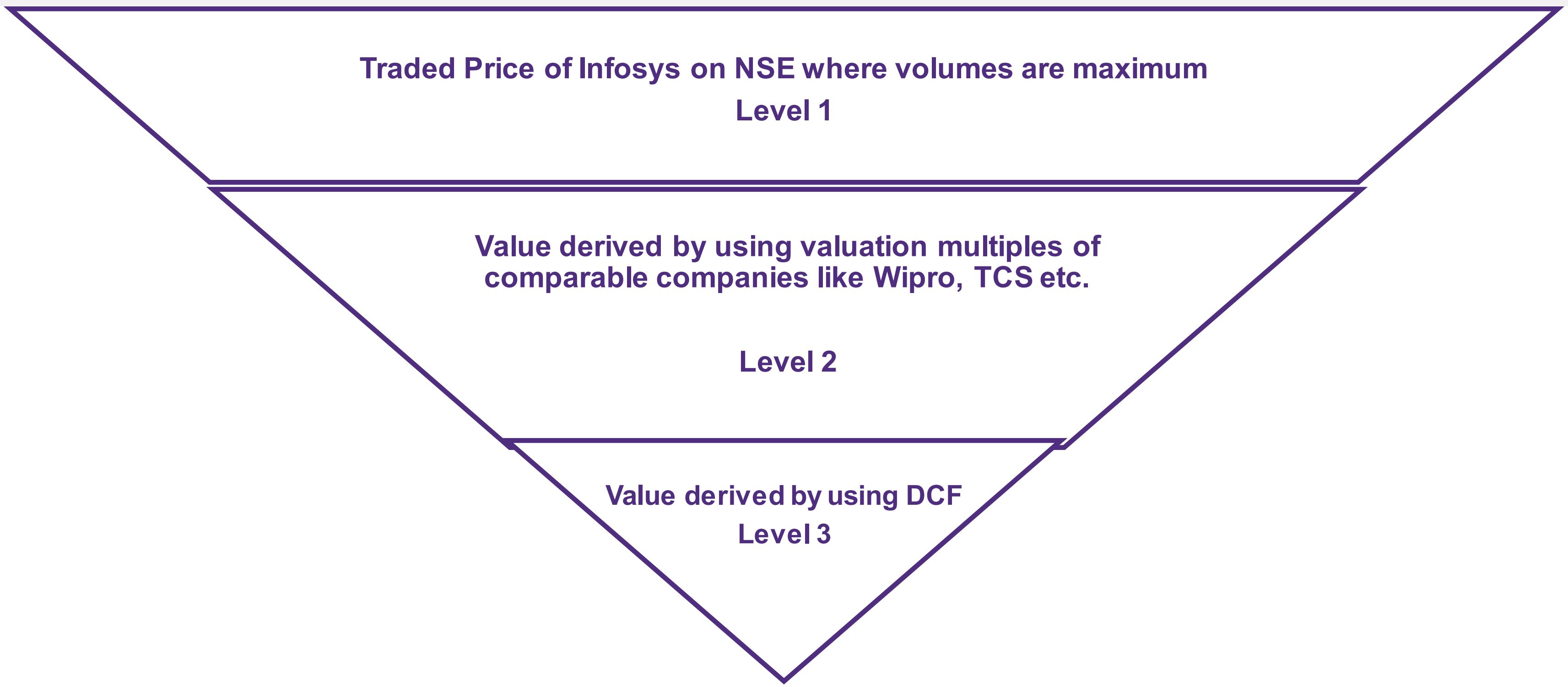
Level 2

unobservable inputs

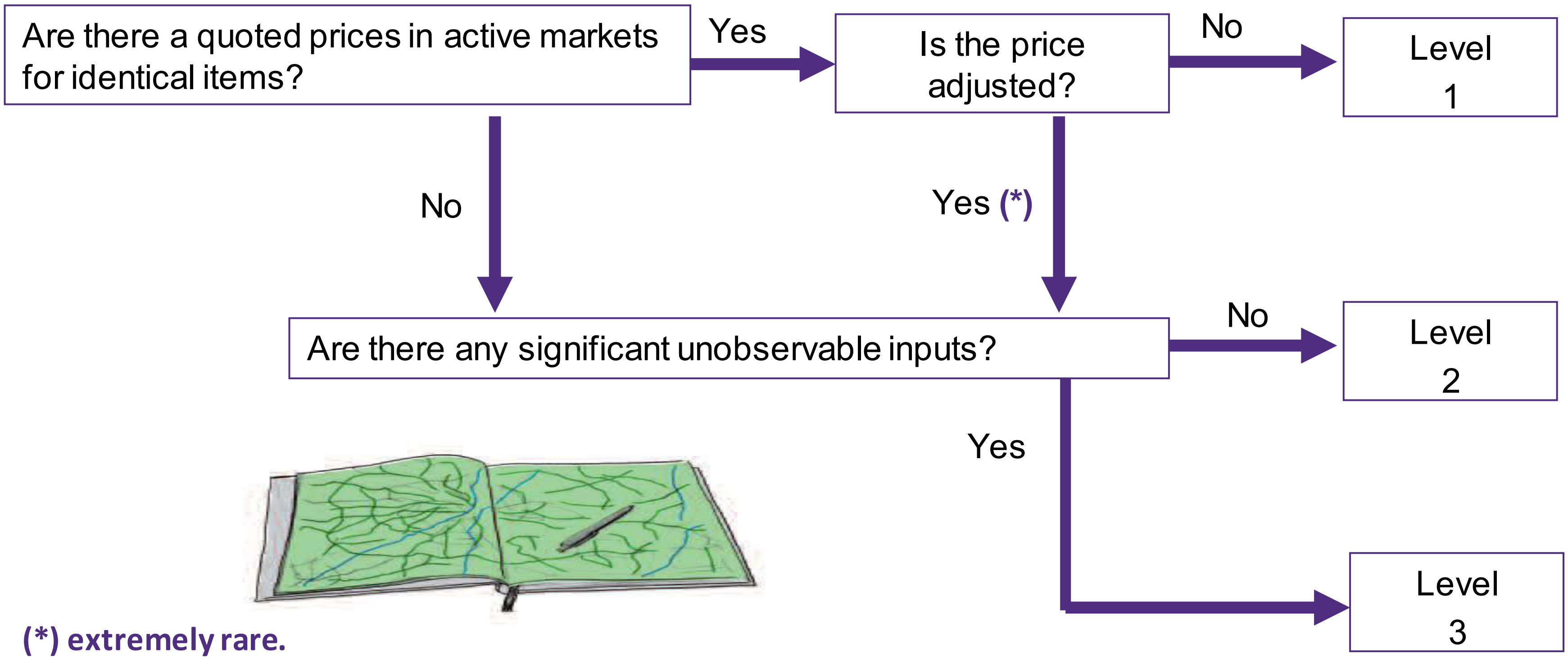
Level 3

Fair value hierarchy

Value of Infosys Shares based on various levels of Inputs



Fair value hierarchy flow chart



(*) extremely rare.

Application to non financial assets – Example

- Entity A acquired a factory which includes:
  plant and equipment, a building and land
- Entity A is not allowed to change the use of the land and the building for a period of 5 years
- other entities have recently received planning consent to redevelop industrial sites in the same region for residential purposes
- Entity A legal consultants' advice is that Entity A could sell the land and the building to a third party and the restriction will not apply on the buyers.

Application to non financial assets – Example

The fair value of the land and building should take into account the possibility of the change of usage since the restriction is a characteristic of Entity A and not a characteristic of the asset.

Therefore, the fair value of the property will be the higher of:

- its **current use** or
- its **use for residential development.**

Disclosures – recurring fair value measurements

1. the **fair value measurement** at the end of the period and the **Level** in the **hierarchy**
2. transfers between **Level 1** and **Level 2** of the hierarchy and reasons for these transfers
3. a **description** of the **valuation techniques, the inputs** used in **Levels 2 and/or Level 3,** any **changes** to the **valuation techniques** and reasons for that change
4. a **narrative description of sensitivity** analysis for **Level 3 measurements** and the effect of changing an **unobservable input** where such a change would affect the fair value significantly.

Disclosures – non-recurring fair value measurements

1. the **fair value measurement** at the end of the period and the **Level** in the **hierarchy**
2. the **policy** for determining when **transfers** between **levels** of the **hierarchy** are deemed to have occurred
3. a **description** of the **valuation techniques, the inputs** used in **Levels 2 and/or Level 3,** any **changes** to the **valuation techniques** and reasons for that change

Valuation Concepts

Business Valuation Methods

Asset Based Valuation Approach

- The Adjusted Net Asset Value is generally used as the minimum break-up value for the Company business. Represents Shareholders Net worth adjusted for contingent liabilities, realizable value of assets and liabilities and **value of intangibles**.

Replacement Cost Method

- Applicability - Generally applied to **highly capital intensive** companies
- **Estimates of costs** on creating a similar facility is needed – Revised Fixed Assets costs
- Apply **depreciation** for the revised cost estimate based on the no. of years of existence
- Add the **market value** of other assets

Key Valuation Constraints

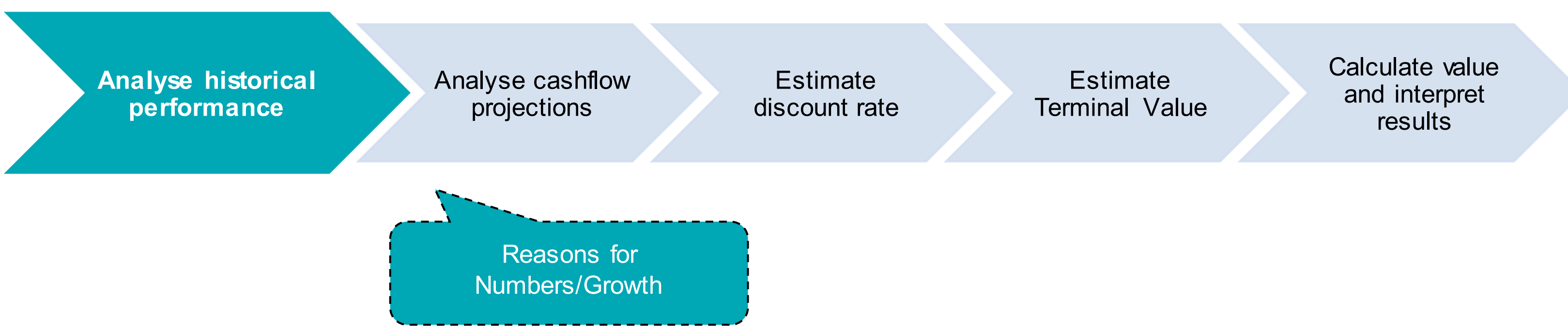
- Difficult to estimate realizable value of assets or replacement of assets with similar utility
- Ignores the future cash generation potential of the business
- **Value of intangibles** and **market value estimates** are not available
- Suitability of the method based on data availability and nature of business such as Power, Oil & Gas, Cement, Infrastructure, Financial sector

Business Valuation Methods (cont’d)

Income based Approach

Discounted Cash Flow (DCF) Method

- The **intrinsic value** of an asset is the **present value of expected future cash flows** from that asset. Uses the future free cash flows of the business discounted by a suitable discount rate to arrive at the net present value
- A strong and widely accepted valuation tool as it concentrates on **cash generation potential of a business**
- Philosophical basis – **Markets prices could vary from intrinsic value** of the asset in short term



Business Valuation Methods (cont'd)

Market Based Valuation Approach (MM)

- Listed Entities – **Stock price on the date of valuation** or historical average price
- Unlisted Entities – **Value based on valuation of comparable listed entities**, in the case of valuation of privately held companies. The challenge is that while there could be "reasonably" comparable companies in the industry, no two companies are similar in all aspects….
- Philosophical basis - **markets are on an average right** and while **individual firms in a sector or market may be mispriced**, the sector or overall market is fairly priced.

Unlisted Companies: Derive multiples from comparable companies

- Adjust for **size, risk and growth factors** of comparable companies
- Apply to **company being valued**
- Adjust for **liquidity & marketability**
- Adjust for **control premium** in case of valuation for acquisitions

Transaction Multiple Method (TM)

- This method takes into account, the value or consideration **paid for similar transactions** in the industry and benchmarks it under certain parameters like EV/ EBITDA and Price /Revenue multiples

Thank you