

## Ind AS 113 - Fair Value Measurement

Fair value is a **market based measurement** and not an entity specific measurement.

What is Fair Value?

Fair Value is the price that would be

- received to sell the asset (**exit price**) or
- paid to transfer a liability (**exit price**)

in an orderly transaction (**no stress sale or liquidation sale**) between market participants (**knowledgeable, unrelated parties**) at the measurement date under current market conditions.

Balance sheet **< items measured at fair value as per Ind AS 113 >**

Financial liabilities measured at fair value in case of FVTPL.

- i) PPE or Intangible Assets measured at fair value in case of Revaluation model.
- ii) Financial Assets measured at fair value in case of FVTPL/ FVOCI method
- iii) Biological Assets measured at fair value less cost to sell.
- iv) Non current asset held for sale (FV-CTS)
- v) Plan Assets measured at fair value.

## Asset or liability specific Fair Value

Fair value measurement takes into account the characteristics of Asset or liability :-

- a) The **Condition** of the asset.
- b) The **location** of the asset.
- c) **Restriction** on sale or use. **< Only Asset or liability specific restriction needs to be considered but Entity specific restriction should not be taken into account as it won't affect other market participants >**

## Example 2: Entity Specific restrictions

An entity is having a land which has a restriction to develop into a commercial house because of restricted business objective in which currently the entity operates. The entity wants to sell the land and there would not be any restriction for a buyer of the land to develop a commercial house, since this restriction is entity specific. Hence, it will not be considered while calculating fair value of the land.

## Example 3: Asset / Liability specific restrictions

A car has been bought for private use and there is a restriction of not to use the car for any commercial purposes. Commercial vehicle is having more fair value than private vehicle. Since the restriction to use the vehicle is asset specific and market participant will also consider the asset specific restrictions while calculating fair values for such asset, hence this condition will be considered while evaluating fair value of the car.

## Unit of Account

An Asset or a liability is aggregated or disaggregated for Recognition or for measurement as per other relevant Ind AS.

< Eg. Fair value measurement of Cash Generating Units >

Ind AS 113 describes how to measure Fair value and not what is being measured at Fair value.

Other Ind AS specifies whether Fair value measurement considers individual Asset/Liability or a group of Assets/Liability.

## Principal market or most advantageous market

A Fair value measurement assumes that transaction to sell the Asset or transfer the liability takes place either in —

(i) Principal market

(ii) In the absence of principal market, the most advantageous market

## Principal Market

Market which is normally the place in which Asset/Liabilities are being transacted with **highest volume** with **high level of activities** comparing with any other market available for similar transaction.

Note ÷ Since Principal market is the most liquid market, therefore price in that market must be used even if price in other market is most advantageous.

## Most Advantageous Market

Market which either maximises the amount to be received when entity sells an asset or minimizes the amount to be paid while transferring the liability.

	<u>Market A</u>	<u>Market B</u>	<u>Market C</u>
Sale Proceeds	500	490	520
(-) Transportation cost	(20) <sub>h80</sub>	(30) <sub>h60</sub>	(35) <sub>h85</sub>
(-) Selling cost	(10)	(8)	(20)
Net amount realised:	<u>470</u>	<u>452</u>	<u>465</u>

∴ Market A is most advantageous.

But Fair value is determined by reducing only transportation cost from Sale Proceeds.

$$\therefore \text{Fair Value} = 500 - 20 = \underline{480}$$

$$\therefore \text{Fair Value} - \text{Cost to sell} = 480 - 10 = \underline{470}$$

Note ÷ Transaction cost is not adjusted to determine Fair value

### Example 7

Shares of a company which is listed at BSE and NYSE have different closing prices at the year end. The price at BSE has greatest volume and activity whereas at NYSE it is less in terms of volume transacted in the period. Since BSE has got highest volume and significant level of activity comparing to other market although the closing price is higher at NYSE, the closing price at BSE would be taken.

### Example 8

Diamond (a commodity) has got a domestic market where the prices are less compared to the price available for export of similar diamonds. The Government has a policy to cap the export of Diamond, maximum upto 10% of total output by any such manufacturer. The normal activities of diamond are being done in the domestic market only i.e. 90% and balance 10% only can be sold via export. The highest level of activities with the highest volume is being done in the domestic market. Hence, the principal market for diamond would be the domestic market. Export prices are more than the prices in the principal market, and it would give the highest return as compared to the domestic market. Therefore, the export market would be considered as the most advantageous market. However, if principal market is available, then its prices would be used for fair valuation of assets/liabilities.

# Applying Fair Value Rules on Non Financial Assets. (E.g. Machinery, Equipments)



## ii) Highest and Best use

The Highest and Best use is a valuation concept used to value many Non Financial Asset (E.g. Real Estate)

The Highest and Best use of a Non Financial Asset must be ÷

- Physically Possible** ∴ Physical characteristics of the asset (E.g. location or size of a property, or conditions)
- legally Permissible** ∴ legal restrictions on use of the asset. (E.g. zoning restrictions applicable to the property.)
- Financially Feasible** ∴ Generates adequate income or cash flows to produce investment return.

All restrictions specific to an entity or specific to any market participants should not be considered while binding Fair values of a Non Financial Asset

In case of Financial Asset, there is no concept of Highest and Best use.

## iii) Valuation Premise

A Fair value measurement of a Non Financial Asset should be based on

- either ÷
- At stand Alone Basis.
  - In combination with other assets.

Standard requires to use best used value if such non-financial asset is used in combination with some other assets and it is demonstrated that such combination is widely used by other market participants also in order to find best use for the non-financial asset.

## Applying Fair Value rules to Liabilities and Entity's own Equity Instruments

A fair value measurement assumes that a Financial or Non Financial liability or an equity instrument is transferred to market participants at the measurement date. (e.g. Equity Instruments issued as consideration in Business Combination)

The standard specifies an assumption that liabilities and/or equity instr. so transferred will remain outstanding on the date of measurement.

standard prescribes to use all observable inputs (if direct quoted price are not available) and should minimize any unobservable inputs.

↳ market data

**OBSERVABLE INPUTS:** Inputs that are developed using market data, such as publicly available information about actual events or transactions, and that reflect the assumptions that market participants would use when pricing the asset or liability (e.g., Stock exchanges, Brokered markets, Dealer markets etc.).

↳ internal data

**UNOBSERVABLE INPUTS:** Inputs for which market data are not available and that are developed using the best information available about the assumptions that market participants would use when pricing the asset or liability (unobservable inputs may include reporting company's own data, adjusted for other available information, e.g., Internally generated financial forecast).

A. When liability and Equity Instruments are held by other parties as Asset.

(i) Direct Quoted Price.

(ii) If Direct Quoted Price not available, the entity should use identical price of similar liabilities or Equity instruments held by market participants as an asset.

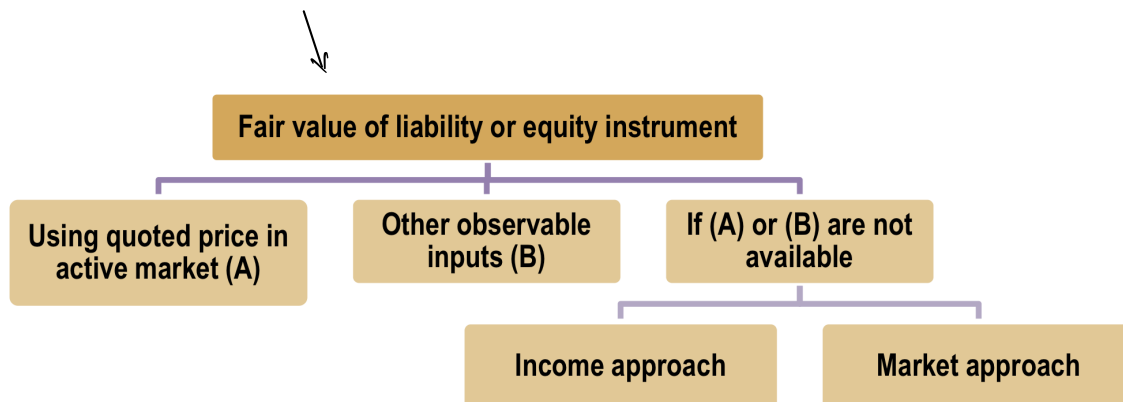
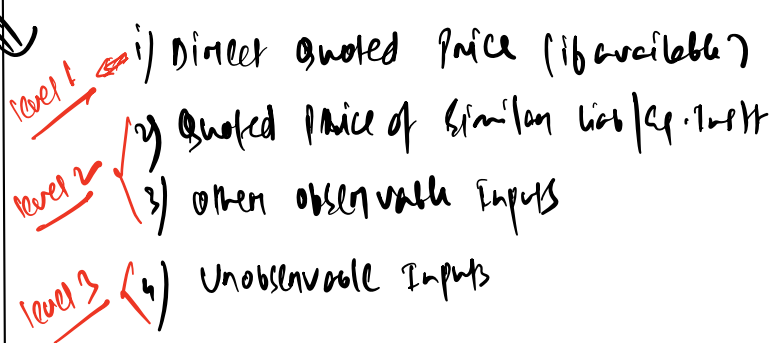
The quoted price of such assets at the measurement date should be used.

B. When liability and Equity Instruments are not held by other parties as Asset.

When these are not held by other parties, then valuation technique from the perspective of a market participant that owes the liability or has issued the claim on equity would be used to evaluate such fair values.

However if Quoted Price not available then other observable Inputs can be used.

In the absence of observable inputs, Valuation technique such as Income approach or market approach may be used.



### Applying Fair Value Rules to Financial Assets:

- a) ~~Highest & Best Use~~
- b) Valuation Premise (Discussed in case of Non-Financial Assets) (E.g., Valuation of single shares or group of shares) Control Premium Concept
- c) Consider restrictions on financial assets:
  - i. Liquidity discount
  - ii. Non-controlling stake discount

} Refer 11K Q3.

### **FAIR VALUE AT INITIAL RECOGNITION:**

When an asset is acquired or a liability is assumed in an exchange transaction for that asset or liability, the transaction price (Entry Price) is the price paid to acquire the asset or received to assume the liability.

In contrast, Fair value of the Asset/Liability should be **EXIT PRICE**.

In many cases, the transaction price will equal the fair value.

But the transaction price might not represent the fair value of an asset or a liability at initial recognition if any of the following conditions exist:

1. The transaction is between **RELATED PARTIES**.
2. The transaction takes place under duress or the seller is forced to accept the price (**Stress sale**).
3. The market in which the transaction takes place is different from the principal market (or most advantageous market).
4. The **unit of account** represented by the transaction price is different from the unit of account for the asset or liability measured at fair value.

## Valuation Techniques

### 1. Market Approach $\langle$ level 1 on level 2 Inputs $\rangle$

This approach uses price and other relevant information generated by market transactions involving identical or comparable (similar) assets or liabilities or a group of assets or liabilities such as Business.

E.g. Price of a Security is determined using Price to Earning ratio with certain adjustments if there are some entity specific restrictions.

$$\langle \text{EPS} \times \text{P/E Ratio} \quad \text{or} \quad \text{EBITDA} \times \frac{\text{EV}}{\text{EBITDA}} \rangle$$

### 2. Income Approach $\langle$ usually level 3 Inputs $\rangle$

In Income Approach, All future earnings or future cash flows to be discounted at current date to get fair value of the asset/liability.

Assumption to the future cash flows and an appropriate discount rates would be based on other market participants views.

$\langle$  Free Cash Flow both the firm or Equity approach  $\rangle$

### 3. Cost Approach $\langle$ Replacement Cost Approach $\rangle$

This method describes how much cost is required to replace existing assets or liabilities in order to make it in a working condition. All related costs will be its Fair value.

## Fair Value Hierarchy (Inputs to valuation techniques)

→ Quoted price + identical asset/liab + active market + No Adjustment

### Level 1 Inputs (most genuine fair value)

Quoted Price in active markets for identical assets or liabilities.

It shall be used without adjustment to measure Fair Value whenever available.

In certain situation, a quoted price in an active market might not faithfully represent Fair Value of an asset or a liability such as when significant events occurs on the measurement date but after the close of trading. In such situation, Entity shall adjust the quoted price to incorporate new information on Fair Value measurement. However if quoted price is adjusted, it will be considered level 2 Inputs. <see below Example 2>

### Level 2 Inputs

Inputs that are observable for the asset or a liability (other than quoted price included within level 1)

Level 2 Inputs include the following → see below examples.

(i) Quoted price for similar assets or liabilities in Active Markets

<Quoted price for identical assets or liabilities included in level 1>

(ii) Quoted price for identical/similar assets or liabilities in Inactive markets.

(iii) Inputs other than Quoted Price that are observable for the asset or liability. Example :-

a) Interest rates and yield curves observable.

b) Implied volatilities. (options)

c) Credit spreads

d) Market corroborated Bonds.

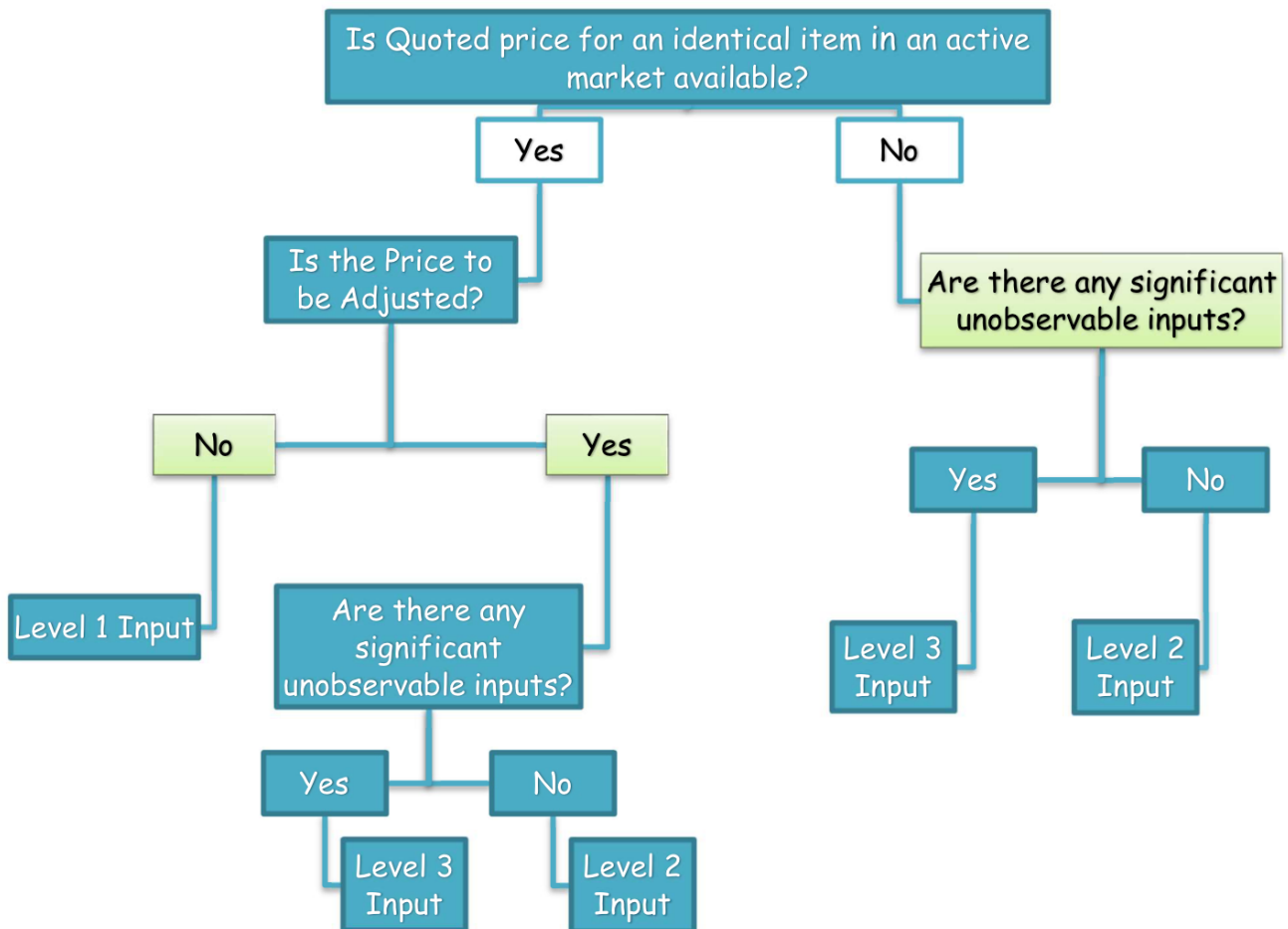
## Level 3 Inputs

level 3 inputs are **unobservable inputs** for the asset or a liability.

Unobservable inputs shall be used to the extent relevant observable inputs are not available

A level 3 inputs would be **financial forecast** < Eg. **Cash flows or Profit or loss** > developed using entity's own data, if there is no reasonably available information that indicates usage of different assumption by market participants.

### SUMMARY:



### Example: 2

A Ltd., a large biotech company with shares traded publicly, has developed a new drug that is in the final phase of clinical trials. B Ltd. has an equity investment in A Ltd.'s shares. B Ltd. determines that the shares have a readily determinable fair value and accounts for the investment at fair value through profit and loss. B Ltd. assesses the fair value as of the measurement date of 31 March 2020. Consider the following:

- (i) On 31 March 2020, the Drug Approval authority notifies A Ltd.'s management that the drug was not approved. A Ltd.'s share closes at ₹ 36 on March 31, 2020
- (ii) A Ltd. issued a press release after markets closed on 31 March 2020 announcing the failed clinical trial.
- (iii) A Ltd.'s shares opened on next working day at ₹ 22.50.

The drug failure is a condition (or a characteristic of the asset being measured) that existed as of the measurement date. B Ltd. concludes the ₹ 36.00 closing price on the measurement date does not represent fair value of the A Ltd.'s shares at 31 March 2020 because the price does not reflect the effect of the Authority's non-approval.

The subsequent transactions that take place when the market opens are relevant to the fair value measurement recorded as of the measurement date. The opening price of ₹ 22.50 indicates how market participants have incorporated the effect of the non-approval on A Ltd.'s stock price.

B Ltd. adjusts the 31 March 2020 quoted price for the new information, records the shares at ₹ 22.50 per share at 31 March 2020 and discloses the investment as a Level 2 measurement.

### Examples of Level 2 Inputs.

1. Receive-fixed, pay-variable interest rate swap based on a yield curve denominated in a foreign currency. It requires rate of swap which is of 11 years. However, normally the rates are available only for the maximum period of 10 years. The rate for 11 years can be established using extrapolation or some other techniques which is based on 10 years' available rates of swap. The fair value of 11 years so derived would-be level 2 fair value.
2. An entity has an investment in another entity which has no active market. However, some similar investment is being traded in an active market. Now, the fair valuation can be done based on either the prices based on the market which is not active or similar traded investment in an active market. This would be considered as level 2 inputs.
3. X and Y each enter into a contractual obligation to pay 500 in cash to D in five years. X has an AA credit rating and can borrow at 6%. Y has a BBB credit rating and can borrow at 12%. X will receive about 374 in exchange for its promise (the present value of 500 in five years at 6%). Y will receive about 284 in exchange for its promise (the present value of ₹ 500 in five years at 12%). The fair value of the liability to each entity (that is, the proceeds) incorporates that entity's credit standing.

Expected labour cost  
(+) Overhead (80% of 131.25)

(+) Profit mark up (20% of 236.25)

(+) Inflation Adj'  $\{ 283.5 \times (1.04)^{10} - 283.5 \}$

(+) Prem 5% of 419.65

131.25
<u>105</u>
236.25
<u>47.25</u>
283.5
<u>          </u>
419.65
<u>20.98</u>
440.63 (10m)

