

Fair Value Measurement as per IND as – An Evaluation of Critical Balance Sheet Items

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ABSTRACT

Fair Value can be defined as 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. It is also called as the exit price since it is calculated as the price to sell as asset rather than the price to buy that asset. Fair value is a market-based measurement rather than an entity-specific measurement. It is measured based on the assumptions used by the market participants to price an asset or a liability subject to its risk. The definition of fair value focuses on assets and liabilities because they are the primary subject of accounting measurement.

This paper focuses on the implications of Fair Value in the accounting measurement of certain critical line items with reference to IND AS 113. The study evaluates the impact of using Fair value measurement in Financial Instruments, Property, Plant and Equipment and Biological Assets. The observations and findings of the study will help corporate to understand the concept of fair value, its measurement methods and its effect.

1. Introduction

Fair value accounting continues to be a topic of significant interest and debate among the preparers and users of financial information. It is an important measurement basis in financial reporting and provides information about what an entity might realize if it sells an asset or might pay to transfer a liability. Ind AS 113 provides guidance on how to measure fair value of financial and non-financial assets and liabilities when it is required or permitted by another Ind AS. This standard does not function in isolation but it acts as a companion standard to other Ind AS. Fair value represents the exit price and not the entry price. The transaction price is considered to be the entry price.

Principal or Most Advantageous Market (POMAM)

POMAM is considered from the perspective of the entity. On the said measurement date, the entity shall have access to POMAM. In the presence of the Principal market, the market price is considered as the fair value of the asset or liability. If Principal market does not exist, the transaction costs and transportation costs are considered while determining most advantageous market but the treatment is different for fair value measurement.

This study focuses on the implications of Fair Value in the accounting measurement of certain critical line items with reference to IND AS 113.

1.1. Objectives

The study has the following objectives;

- To examine the concept of fair value and the advantages and limitations applied in financial accounting.

- To study the approach to the accounting measurement of fair value with regard to certain critical line items of Balance Sheet.
- To study the impact of implementing fair value approach on the qualitative characteristics of accounting information and its impact on decision making.

1.2. Research Methodology

The study is based on descriptive research design as it describes the impact of fair value measurement on various line items of Balance sheet. The study is based on secondary data referred from government reports and various accounting standards.

1.3. Review of Literature

- ❖ Silva et.al. studied how important the fair value method of biological assets among the users of accounting information. The study aimed to find the relevance of results arising from fair value, type of biological asset (based on liquidity) and whether the fair value has a influence on the management's decision. The findings of the study revealed that FVM of biological assets were much better than the historical cost and impact of FV even without active market was highly necessary than with net market.
- ❖ Cavalheiro et.al., (2017) the author empirically tried to approach the fair value measurement of biological assets in a non-active market. Data was collected through reports and interview and evaluated through discounted cash flow.

- ❖ PhD Olivera et.al. discuss about the pros and cons of implementing fair value accounting in business. They also highlight the significant implications of fair value under different items of financial statements.
- ❖ Alfatih and Suleiman (2015) did an empirical analysis on the impact of fair value on the quality of accounting information. They have framed hypothesis to understand the impact under various parameters and measured it through statistical tools.

1.4. Limitations of the study

The study is limited only to certain critical line items of Balance sheet and does not cover the implications of Fair value in all items.

2. Fair Value Measurement of Financial Instruments

The fair value of a financial asset or liability on a given date is the amount for which it could be exchanged or settled, respectively, on that date between two knowledgeable, willing parties in an arm's length transaction under market conditions. The most objective and common reference for the fair value of a financial asset or liability is the price that would be paid for it on an organized, transparent and deep market ("quoted price" or "market price").

2.1. Measurement Techniques

While measuring the fair value of an asset or a liability, an entity shall select those valuation approaches and techniques which are appropriate and have sufficient data available to measure fair value. The technique selected by the entity shall maximize the use of relevant observable inputs and minimize the use of unobservable inputs. Valuation approach refers to the broad category of techniques available whereas valuation technique refers to a specific technique adopted by an entity. There are three approaches to measure fair value of financial instruments. They are market approach, income approach and cost approach.

If more than one valuation technique is available for an entity, then it can consider the reliability of the valuation techniques and the inputs which are used in the techniques. A market based approach relies on higher level inputs such as observable market prices whereas the income based approach depends more on the projections of income. In that case, the entity would rely more upon the market based approach since it has higher level inputs.

2.2 .Main Assumptions

The measurement techniques are chosen based on certain assumptions. The present value method aims to determine the current value of financial instruments as the current value of future cash flows which are discounted at market interest rates. This assumption is based on the estimate of prepayment rates, issuer credit risk and the current market interest rates. In case of trading derivatives, the options are measured through generally accepted valuation models, to which the observed implied volatility is added.

2.3. Benefits of FVM

- ❖ Fair value measurement utilizes information which are specific for the time and considers current market

conditions. It provides the most relevant estimates at a maximum possible extent.

- ❖ The assets and liabilities are valued at more accurate rate using fair value method. The financial instruments when valued at fair value will be mostly equal to the current market price.
- ❖ Fair value method justifies that the real value of the financial instruments are derived which are supported by relevant methodology, assumptions, risk exposure and other related sensitivities.
- ❖ Fair value approach restricts the entities to manipulate the accounting data at time of sale of investments.

3. Fair Value Measurement of Property, Plant & Equipment

The asset side of the balance sheet classified in descending order value, displayed the category of assets owned by the company and used for deployment in an attempt to generate business income and profits.

The first category of assets classified in this manner holding high value and hence requiring large capital outlays were traditionally described as Fixed Assets. With the emergence of modern business demands the category of fixed assets are being more meaningfully described as Plant, Property & Equipment.

3.1. Main Assumptions & Measurement Methods

The valuation of PPE becomes significant for the fulfillment of several objectives such as

- to estimate the useful life of the asset
- estimate depletion of value of asset (described as depreciation and impairment) to assess the impact of the use and the standing value of the asset leading to measurement of true and fair value of profits
- to have an accurate estimate of the asset to add up to an accurate value of the organization on a going basis

The cost of acquisition proven by appropriate accounting records forms the basis of recognizing the value of the asset on the balance sheet.

While the historical cost of acquisition is accepted as the right method of recognizing the appropriate value of the asset, the chances of non-standardized use of the asset, changes in technology, availability of cheaper substitutes are some of the reasons as to why another method of valuation of PPE is chosen for valuation of PPE in subsequent years. This method is christened as Revaluation method which in sum and substance means to reassess the fair value of the machinery.

3.2. Valuation of PPE – Some Gaps & Perceptions

The Valuation of PPE in an attempt to achieve a Fair Value Measurement is permitted the use of Revaluation Method keeping the historical cost as the starting point. While there can be no objection in principle to this approach, the transition from historical value to going value is effected through the effect of depreciation and impairment.

The question then comes – Is it not right to say Historical cost- Depreciation = Fair value? Especially when Ind AS prescribes the use of No of Units Produced method for calculating Depreciation in contradiction to the traditional WDV method of depreciation? If yes then why do we need Revaluation method at all?

The answer to these questions lies in the fact while Historical cost less depreciation could be an indication of fair value it cannot be prima facie assumed to be the fair value since business events such as the non-standardized use of the asset, changes in technology, availability of cheaper substitutes could significantly alter the fair value of the asset in comparison to the stated book value. The difference between the two would appropriately get accounted as Profit/Loss on sale of PPE.

3.3. Benefits of FVM

The following benefits flow out of the implementation of FMV with respect to PPE

1. Increased accuracy in the estimation of asset value
2. Increased accuracy in estimating the life cycle time of the asset
3. Achievement of Objectives 1 & 2 above cascading better establishment of true and fair value of reporting.
4. Lesser disputes in measuring the value of business as a going concern

3.4. Challenges in implementing FVM in the Indian Business scenario:

1. The duality of options available in IND AS, as to whether the user can adopt Historical cost method or revaluation method leads to choice of convenience for users to stick to historical cost method and shy away from the use of revaluation method.
2. Even assuming an acceptance of Revaluation method as a tool of PPE valuation, the legal convenience of different kinds of business organizations (whether connected or not) being allowed to follow different methods of asset valuation prevents the implementation of common standard cutting across organizations.

The need of the hour is to recognize the advantages of implementation and to accept the courage to implement the change amongst digressing peers to set a standard or an example to follow.

4. Fair Value Measurement of Biological Assets

The introduction of new concept called biological asset was not studied in our literature in previous GAAP while preparing financial statements. Bearer biological assets are covered under Ind AS 16 while consumable biological asset comes under Ind AS 41. Living animals come under the scope of ind AS 41. Livestock comparatively have an active market unlike plants therefore can be valued at fair value than cost. Whereas biological assets held for sale/ disposal, are valued at fair value less costs to sell.

4.1. Measurement Techniques

According to initial recognition, the biological are measured at fair value less cost to sell. If the fair value can be measured reliably. Biological asset is required to be measured at the end of every reporting period at its fair value less costs to sell under subsequent measurement. Gain or loss arising from a change in the fair value less costs to sell is to be recognized in the profit or loss for the period in which it arises.

4.2. Main Assumptions

Biological assets are part of non- financial asset and hence it takes market participants ability to generate economic benefits by using the asset to its highest capacity and best use under FVM. The highest and best use of a non- financial asset aims at asset that is physically possible, legally permissible and financially feasible.

This is basically for current use but if the entity does not want to use the assets at its highest and best use for competitive purpose still the fair value of the asset reflects the highest and best use.

4.3. Valuation Techniques

A particular valuation technique can be selected and it must be used consistently to maximize the use of related observable inputs which can reduce unobservable inputs. Under fair value hierarchy there are three level based on the quantitative according to the quantitative disclosure.

Technique / approach	Description	Suitability
Market approach	The prices and other relevant information developed by market transactions involving similar assets, liabilities or group of assets and liabilities.	Yes this approach is suitable for biological assets when active market exist. Eg. Livestock. This would similarly be applicable if agriculture produce like leaves on tea bushes and rubber trees if active market exist to determine the fair value
Income approach	If an entity converts its future cash flows or income and expense to a discounted amount.	Yes this approach is suitable for biological assets when there is a non- active market. It would be necessary when growing produce on bearer plants considering a large number of unobservable inputs. Discounted cash flow is the most applicable valuation technique.
Cost approach	Value which reflects the amount that would be required currently to replace the service capacity of an asset (i.e. current replacement cost)	Not suitable for biological assets.

4.4. Challenges in Implementation of FVM in Indian Scenario

Ind AS 41 Agriculture is a new concept which was not existing in the previous GAAP. Therefore, it is the first time to assess the items relating to biological assets and application of

valuation techniques. The key issues faced during the application in Indian scenario are:

- Identifying the items of biological assets based on the nature.
- Difficulties faced in estimating the fair value.
- Difficulty in evaluating the biological assets.
- When there is no active market existing, the difficulties in estimating the fair value.
- Evaluating the suitable approach in measuring all biological assets

The cost and benefit of adopting fair value model for the biological assets.

5. Observations

5.1. Financial Instruments

Financial instruments can be measured more fairly and accurately under fair value method. Even though, this method nullifies the historical perspective of the investments. Investors won't prefer this method since the loss of value creates dissatisfaction among investors. In spite of the advantages and disadvantages of the method, the entity will face several challenges in arriving at the fair current market price which can be manipulated.

5.2. Property, Plant & Equipment

Fair value in PPE provides the real value of the assets held by the company. Even though, this method evaluates the assets at real fair value, the corporates still go for historical cost

method for convenience purpose. Ind AS has provided option to the firms to implement fair value of PPE in place of cost method and this choice has made the companies to stay with historical cost method.

5.3. Biological Assets

Now, the companies must recognize and measure biological assets that was not necessary in the previous GAAP. For the purpose of fair valuation determination of volume of produce is a biggest challenge. It becomes a challenge for the companies to exercise best judgement in determining the valuation technique in consultation with the experts for the biological assets. It is necessary for extensive disclosure to be provided for Ind AS 113 in their financial statements.

6. Conclusion

The cost of investment in various assets can be measured under historical cost method. But fair value approach provides the return expected by the management on their investments. It is very much ideal and relevant to know the fair value of the assets and liabilities but still its equally important to know the cost of the investment as well. Under various parameters, fair value provides exact real information to the investors, company and other stakeholders about the assets and liabilities. Looking into the increased advantages, the corporates shall implement fair value accounting for the relevant line items of Balance Sheet in the upcoming financial statements.

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