The Institute of Chartered Accountants of India

Concept Paper
On
All about Fair Value

**ICAI Registered Valuers Organisation
and
Valuation Standards Board
The Institute of Chartered Accountants of India**

As we all know that Valuation is the process of estimating the fair value of a financial asset or liability of the business or an individual which is required for investment analysis, capital budgeting, merger and acquisition transactions, financial reporting, taxable events to determine the proper tax liability, and in litigation.

The Institute of Chartered Accountants of India (ICAI) converged accounting standards with IFRSs and accordingly, the financial statements beginning from the accounting year 2016-17 started disclosing financial figures based on fair value measurement. One of the purposes of fair value measurement is to reduce the gap between the balance sheet value (historical cost) and market value (fair value) of a company. The fair value measurement of a non-financial asset takes into account a market participant's ability to generate economic benefits by using the asset in its highest use.

ICAI has also issued "ICAI Valuation Standards-2018" and the Standards have been formulated to meet the requirement of giving guidance/ valuation to determine the "Fair Value" as per Ind AS 113 as notified by the Ministry of Corporate Affairs. With the introduction and the subsequent adoption of Ind AS by many Indian companies, the emphasis on valuation has increased.

We at ICAI as well ICAI RVO are committed to provide continued knowledge and support to the Registered Valuers, Professionals and other stakeholders.

Looking at the importance, ICAI Registered Valuers Organisation and Valuation Standards Board of ICAI, thought to bring out a Concept Paper on "All about Fair Value" to help the Registered Valuers, other stakeholders to make them aware about various aspects of Fair Value. I acknowledge the efforts of CA. Pramod Jain, Chairman, Valuation Standards Board, and CA. Dheeraj Khandelwal, Vice Chairman, in bringing out this Concept Paper and to the members of the Board of ICAI RVO.

This Concept Paper is based on the Study/ Research done by our Registered Valuer, CA. Parag Kulkarni.

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President, ICAI and Director ICAI RVO

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1. Introduction

Financial reporting in India has undergone a significant transformation owing to the adoption of Indian Accounting Standards (Ind AS) and fair value is the guiding principle in financial reporting across the globe. The Institute of Chartered Accountants of India (ICAI) converged accounting standards with IFRSs and accordingly, the financial statements beginning from the accounting year 2016-17 started disclosing financial figures based on fair value measurement. Fair value is a common basis of value associated with financial reporting valuations and is utilised throughout the Indian Accounting Standards.

It 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 valuation date.

In the year 2018, ICAI has also issued ICAI Valuation Standards, 2018 and the Standards have been formulated to meet the requirement of giving guidance/ valuation to determine the "Fair Value" as per Ind AS 113 as notified by the Ministry of Corporate Affairs.

The increasing importance placed by international accounting authorities on Fair Value (FV) reinforces the need for the consistent use of valuation practices worldwide. Fair value accounting can make entities' businesses appear more volatile than they actually are. Fair value accounting is argued to facilitate investors' risk assessment through transparent reporting of underlying business. However, measurement issues and misunderstanding of fair value information may lead to excess stock price volatility.

The Revised Model Business Corporation Act (RMBCA) of United States defines fair value as:

"The value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable."

Fair Value is the standard of value currently used in at least two legal contexts. The first use of Fair Value is that it is the standard of value used in financial statement accounting for publicly traded companies.

2. Fair Value and Ind AS

With the introduction and the subsequent adoption of Ind AS by many Indian companies, the emphasis on valuation has increased.

The basis of value is closely related to the purpose of a given valuation exercise and can often vary. Selecting an appropriate basis of value is critical. For example, Fair Value is generally used for financial reporting purposes while Fair Market Value is used for tax reporting purposes. Other standards of value include investment value, liquidation value etc. Investment value reflects the value to a specific buyer/seller while liquidation value reflects the possible price of a business or an asset when operations are being discontinued or the assets/liabilities are being sold piece meal.

3. Definition of Fair Value as per Ind AS- 113

Typically, Fair Value is a commonly utilized basis of value. Ind AS 113 – Fair Value Measurement defines Fair Value 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.

4. Key aspects of Fair Value as per Ind AS 113

Key aspects of Fair Value as per Ind AS 113 include:

- Fair Value is based on the exit price i.e. the price that would be received to sell an asset or paid to transfer a liability, not the transaction price or entry price or the price that was actually paid for the asset or that was received to

assume the liability. Generally, entry and exit prices are different. The idea of exit price is based on expectations about the sale or transfer price from the perspective of market participants as of the valuation date.

- Fair Value emphasizes the concepts of a "principal market" and the "most advantageous market" with respect to the business/asset being valued. The principal market is defined as the market with the greatest volume and level of activity for the subject asset or liability. Ind AS 113, specifies that in the absence of a principal market, the most advantageous market should be considered. The most advantageous market is the market that maximizes the amount that would be received to sell a given asset or minimizes the amount that would be paid to transfer the liability, after taking into account transaction costs and transportation costs.

- Fair Value measurements should reflect market participant assumptions in pricing an asset or liability. Market participants are assumed to be buyers and sellers in the principal (or most advantageous) market that are knowledgeable independent, unrelated parties willing and able to transact for the asset or liability being Fair Valued without compulsion.

- The highest and best use ("HABU") of a nonfinancial asset or group of nonfinancial assets and nonfinancial liabilities is the use by market participants that maximises the value of the nonfinancial assets/liabilities. This Fair Value concept considers (i) the different ways of utilizing the individual asset/liability, i.e. the highest and best use, and (ii) the valuation premise, whether the maximum value is on a standalone basis or in combination with other assets.

- Fair Value measurements should consider characteristics of the assets/liabilities being valued such as the condition, location, restrictions associated with the sale or use of an asset as applicable. Liability fair valuations should reflect non-performance risk.

5. Fair Value may not be equal to Transaction Price

- When transaction is between related parties

- Where transaction occurs under duress or force

- Unit of account represented by the transaction is different from that of the asset or liability

- Market in which the transaction occurs is different from the principal or most advantageous market
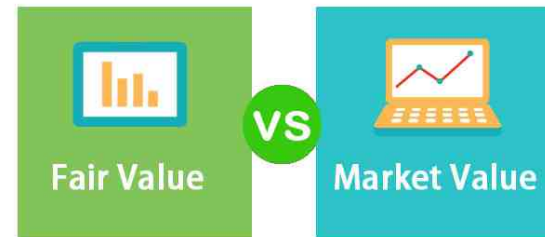
6. Fair value for Financial Reporting vs. Fair Market Value (FMV)

- Fair value has a hierarchy of inputs for Valuation but FMV does not have it

- Fair Value uses HABU for non – financial assets Valuation resulting in maximising value against consensus value under FMV

- DLOM adjustments may be required in certain cases under Fair Value but DLOC is doubtful

- Fair value disregards blockage discount (decline in value due to size)

Fair value is usually synonymous to fair market value except in certain circumstances where characteristics of an asset translate into a special asset value for the party(ies) involved.

A comparison of some of the differences between the Fair Market Value standard and concept of Fair Value is outlined below:

(a) *Awareness of Facts*

While the fair market value standard requires both the buyer and seller to be aware of all facts and circumstances that are relevant to the valuation, the fair value standard does not require any such knowledge, nor is the knowledge required of both parties. The concept of Fair value anticipates

that the willing buyer and willing seller will be "well informed", while standard of Fair market value requires that the willing buyer and seller should be reasonably aware of all relevant facts and circumstances. While the two terms appear to be similar, they are not. A well informed party may still be unaware of all the facts and circumstances relevant to the valuation.

(b) Compulsion to buy or sell

Fair market value standard requires that neither the willing buyer nor the willing seller is under any compulsion to buy or sell the property that is the subject of the valuation. Fair value standard states that the property should not be the subject of a forced sale or liquidation. There is a difference between the two terms. A party may wish to liquidate voluntarily without being under some internal compulsion. Also, it is possible that one of the parties is being forced into the transaction while the other party is at free will. Fair market value standard strictly requires that neither party be under any compulsion.

(c) Fair value uses the highest and best use of an asset from the perspective of market participants. This may result in maximizing the value as against consensus value under FMV

(d) DLOM adjustments may require in certain cases under fair value but adjustment for DLOC is doubtful.

(e) Fair value disregard blockage discount (a decline in the value resulting from the size of position). The opinion of FASB is clear that when a quoted price is available in the active market it should not be further reduced for blockage discount. Because the quoted price is without any regard to the intent of the firm to transact at that price. Without the blockage discount comparability will improve.

Thus, it may be inferred that fair value is a broader term than the fair market value standard. In some respects, fair value encompasses fair market value.

7. Characteristics of Asset or liability that is the subject of measurement

A fair value measurement is for a particular asset or liability. The characteristics of the asset or liability that market participants would take into account when pricing the asset or liability at the measurement date shall be taken into account. Such characteristics include:

* the condition and location of the asset

* restrictions, if any, on the sale or use of the asset

The asset or liability measured at fair value might be either of the following:

* a stand-alone asset or liability (e.g. a financial instrument or a non-fi n a n c i a l asset);

    or

* a group of assets, a group of liabilities or a group of assets and liabilities (e.g. a cash-generating unit or a business).

8. Principal (or most advantageous) market

The transaction to sell the asset or transfer the liability takes place either:

* in the principal market or

* in the absence of a principal market, in the most advantageous market.

9. Highest and best use for a non-financial asset

A fair value measurement of a non-financial asset takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use. The highest and best use of a non-financial asset takes into account the use of the asset that is

a.   Physically Possible

b.   Legally Permissible

c.   Financially feasible

Highest or best use is usually (but not always) the current use – if for competitive reasons an entity does not intend to use the asset at its highest and best use, the fair value of asset still reflects its highest and best use by market participants (defensive value).

10. Fair value hierarchy

To promote consistency and comparability in fair value measurements, Ind AS 113 establishes a Fair Value hierarchy that categorises valuation related inputs into three levels, namely:

- ***Level 1 inputs***

  These inputs are quoted prices (unadjusted) in active markets for identical assets/liabilities that the entity can access at the measurement date. As a quoted price in an active market provides the most reliable evidence of Fair Value, it should be utilized to measure Fair Value whenever available.

  Common examples of Level 1 inputs include listed equity securities and open ended mutual funds with daily published net asset values.

- ***Level 2 inputs***

  These inputs are other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.

  Level 2 inputs include

  (i)   quoted prices for similar assets or liabilities in active markets;

(ii)   quoted prices for identical/similar assets or liabilities in markets that are not active;

(iii)   inputs other than quoted prices that are observable for the asset or liability, such as interest rates, yield curves, and implied volatilities; and

(iv)   market-corroborated inputs.

Adjustments to Level 2 inputs vary depending on factors specific to the asset or liability, including

(i)   condition or location of the asset;

(ii)   the extent to which inputs relate to items that are comparable to the asset or liability; and

(iii)   the volume or level of activity in the markets within which the inputs are observed.

- ***Level 3 inputs***

These inputs are unobservable inputs for assets/liabilities. Unobservable inputs are used to measure Fair Value to the extent that relevant observable inputs are not available. The unobservable inputs should reflect the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk.

An entity should develop unobservable inputs using the best information available. In developing unobservable inputs, an entity may begin with its own data, but it should adjust the data to ensure consistency with a market participant view point.

Common examples of Level 3 inputs include management prepared business forecasts utilized in a discounted cash flow model.

In estimating the Fair Value of an asset/liability, valuation techniques are used that are appropriate under the circumstances and for which sufficient

data is available to measure Fair Value, thus maximising the use of relevant observable inputs and minimising the use of unobservable inputs.

In some cases a single valuation technique will be appropriate, for example when valuing an asset/liability using Level 1 quoted prices in an active market for identical assets/liabilities.

In other cases, multiple valuation techniques can be considered i.e. when valuing a cash-generating unit. If multiple valuation techniques are used, the results should be evaluated considering the reasonableness of the range of values.

Valuation techniques used to measure Fair Value should be applied consistently. However, a change in a valuation technique or its application is reasonable if the change results in a measurement that is equally or more representative of Fair Value under the circumstances (for example a change in the entity's product offerings, a change in business environment, a change in the industry or market conditions etc).

11. Regarding the highest and best use of a non-financial asset establishes the valuation premise used to measure the fair value of the asset

The highest and best use of a non-financial asset establishes the valuation premise used to measure the fair value of the asset, as follow

- sthe highest and best use of a non-financial asset might provide maximum value to market participants through its use in combination with other assets as a group (as installed or otherwise configured for use) or in combination with other assets and liabilities (e.g., a business)

  ➢ if the highest and best use of the asset is to use the asset in combination with other

assets or with other assets and liabilities, the fair value of the asset is the price that would be received in a current transaction to sell the asset assuming that the asset would be used with other assets or with other assets and liabilities and that those assets and liabilities (i.e. its complementary assets and the associated liabilities) would be available to market participants;

➢ liabilities associated with the asset and with the complementary assets include liabilities that fund working capital, but do not include liabilities used to fund assets other than those within the group of assets;

➢ assumptions about the highest and best use of a non-financial asset shall be consistent for all the assets (for which highest and best use is relevant) of the group of assets or the group of assets and liabilities within which the asset would be used.

● the highest and best use of a non-financial asset might provide maximum value to market participants on a stand-alone basis. If the highest and best use of the asset is to use it on a stand-alone basis, the fair value of the asset is the price that would be received in a current transaction to sell the asset to market participants that would use the asset on a stand-alone basis.

12. Consideration for determination of value based on highest and best use, where the highest and best use is different from the existing use

Where the highest and best use is different from the existing use, costs, to be incurred, if any for conversion of an asset to its highest and best use need to be considered for determination of value based on highest and best use.

13. Analysis of Application of Fair Value Accounting in S&P 500 Companies

An analysis of 505 Companies listed on S&P500 in identifying data related to fair value accounting since year 1990 has been done. In this empirical research, following are the findings:

- Since year 1990 to year 2004, fair value accounting is not at all observed.

- Immediately after the subprime crisis, in calendar year 2008, highest impact of fair value accounting was observed. Banks were hit most (Average impact of (-) $1,575.75 Million(m) for 19 entities) with highest impact onto JPMorgan Chase & Co. with impact of (-) $13,169m for Year 2008 & (-) $9,840m for Year 2009. Second highest impacting Bank was Bank of America Corporation with impact of (-) $ -12,136m for year 2008 but (+) 10,645m for year 2009.

- On the other hand, Capital Market Industry reported highest gains on account of fair value accounting in year 2008 to the tune of average (+) $99,717.53m for 22 entities. The Goldman Sachs Group, Inc. reported total gain of (+) $2,193,888m in year 2008 but reported loss of (-) $129,285m, (-) $2,371m, and (-) $9,328m for year 2009, 2010, and 2011 respectively.

- For recent financial reporting for calendar year 2018, capital market industry (represented by 22 companies) reported average impact of (+) $251.31m on account of fair value accounting.

5 Industries that has highest (+)ve impact on Fair Value A/c in Annual Report of Yr. 2018	No. of Entities under Study	Average Impact in $ in Million
Capital Markets	22	251.31
Interactive Media and Services	5	241.20
Insurance	21	111.36
Real Estate Management and Development	1	100.42
Banks	19	87.64
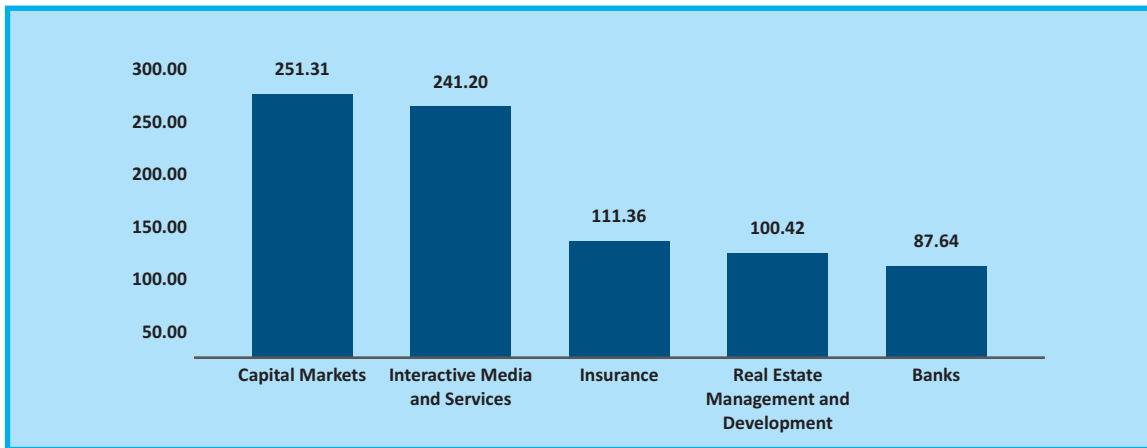
5 Industries that has highest (-)ve impact on Fair Value A/c in Annual Report of Yr. 2018	No. of Entities under Study	Average Impact in $ in Million
Diversified Financial Services	1	(118.00)
Media	12	(27.50)
Health Care Providers and Services	16	(14.89)
Independent Power and Renewable Electricity Producers	2	(7.00)
Electric Utilities	14	(6.38)

Industries that did not observe impact of fair value accounting are - Aerospace and Defence, Air Freight and Logistics, Auto Components, Automobiles, Commercial Services and Supplies, Communications Equipment, Distributors, Diversified Consumer Services, Diversified Telecommunication Services, Entertainment, Gas Utilities, Health Care Technology, Household Products, Software, Specialty Retail, Technology Hardware, Storage and Peripherals, and Tobacco.

14. Analysis of Fair Value Impact in Financial Statements of Nifty 50

A further study of the impact of fair value accounting in Indian context over Nifty 50 Companies since FY 1989-90 has been done and it is found that such impact was never observed until FY 2015-16.

Following table summarised key impacting areas such as Debt Equity Ratio, Net Profit Ratio, and Current Ratio in 23 different sectors representing 50 listed entities.

Type of Industry	Number of Entities under Consideration	Impact of Fair Value A/c in USD Million	Average Debt Equity Ratio in Year 2018	Average Debt Equity Ratio in Year 2015	Average Net Profit Ratio in Year 2018	Average Net Profit Ratio in Year 2015	Average Current Ratio for Year 2018	Average Current Ratio for Year 2015
Automobiles	6	76.09	37.65%	43.56%	11.76%	7.86%	1.34	1.30
Banks *(Could not achieve exact data so excluded from Average Column)*	7	☐	0.00%	0.00%	19.77%	29.05%	☐	☐
Chemicals	2	3.81	39.18%	31.96%	11.94%	9.69%	1.76	1.47
Construction and Engineering	1	(360.12)	178.89%	197.29%	6.09%	5.12%	1.30	1.22
Construction Materials	2	25.58	77.04%	45.14%	5.98%	7.04%	0.97	0.90
Consumer Finance	1	32.98	377.09%	555.34%	30.66%	26.85%	3.17	3.39
Diversified Telecommunication Services	1	☐	0.00%	15.24%	37.66%	17.08%	4.19	1.13
Electric Utilities	1	0.99	241.62%	250.38%	27.39%	28.58%	0.43	0.39
Food Products	2	4.24	3.61%	6.68%	12.21%	7.87%	2.23	1.41
Gas Utilities	1	☐	7.72%	51.12%	8.81%	5.21%	0.97	0.97
Household Products	1	18.75	0.00%	1.06%	14.67%	13.65%	1.31	1.08
Independent Power and Renewable Electricity Producers	1	☐	124.44%	123.88%	11.97%	12.39%	0.86	1.16
Insurance	1	244.10	188.43%	173.57%	8.09%	15.63%	1.17	0.73
IT Services	5	(2.97)	8.53%	5.64%	17.62%	18.74%	3.04	2.75
Media	1	(1.04)	20.14%	0.04%	22.12%	20.02%	3.70	3.61
Metals and Mining	4	76.11	115.12%	167.34%	9.02%	4.96%	1.09	1.17
Oil, Gas and Consumable Fuels	5	11.67	56.80%	60.58%	6.64%	7.96%	0.84	1.31

Type of Industry	Number of Entities under Consideration	Impact of Fair Value A/c in USD Million	Average Debt Equity Ratio in Year 2018	Average Debt Equity Ratio in Year 2015	Average Net Profit Ratio in Year 2018	Average Net Profit Ratio in Year 2015	Average Current Ratio for Year 2018	Average Current Ratio for Year 2015
Pharmaceuticals	3	11.35	30.94%	28.77%	8.06%	14.01%	2.00	1.87
Textiles, Apparel and Luxury Goods	1	3.00	33.24%	3.24%	7.01%	6.85%	1.76	1.80
Thrifts and Mortgage Finance	1	71.53	0.00%	0.00%	22.62%	29.71%	☐	☐
Tobacco	1	116.41	0.07%	0.84%	25.94%	24.88%	2.85	2.10
Transportation Infrastructure	1	(1.42)	104.68%	162.27%	32.44%	37.62%	3.56	1.24
Wireless Telecommunication Services	1	4.24	142.10%	121.01%	1.33%	5.63%	0.43	0.42
Grand Total	**50**	**20.70**	**55.28%**	**63.42%**	**14.15%**	**14.09%**	**1.47**	**1.30**

From above table, it can be easily identified that after usage of fair value accounting, average Debt Equity Ratio is improved from 63.42% to 55.28%, Net Profit Ratio is marginally improved from 14.09% to 14.15%, and Current Ratio is improved from average 1.30 to 1.47.

15. Factors influencing Fair Value

The estimation of Fair Value assumes that the time period required to consummate a transaction hypothetically began at a point in time in advance of the Measurement Date such that the hypothetical exchange culminates on the Measurement Date.

Therefore, Fair Value should reflect the actual amount that a seller would receive in an Orderly Transaction under current market conditions at the Measurement Date. An additional discount for Marketability (where Marketability is defined as the time required to complete a transaction) is not appropriate.

However, liquidity or illiquidity (meaning the frequency of transactions) is taken into account by Market Participants and therefore should be a factor used in assessing Fair Value.

16. Old Vs. New Definition of Fair Value

There are some jurisdictions/ Non IFRS Countries that still define fair value using "willing buyer and willing seller". The new definition is based on 'an exit price from the perspective of a market participant that holds the asset or owes the liability at the measurement date'

The previous definition of fair value (In Indian Context):

• did not specify whether an entity is buying or selling the asset;

• was unclear about what is meant by settling a liability because it did not refer to the creditor, but to knowledgeable, willing parties; and

• did not state explicitly whether the exchange or settlement takes place at the measurement date or at some other date.

New definition of fair value (under Ind AS 113 in Indian Context) conveys more clearly that fair value is a market-based measurement, and not an entity-specific measurement, and that fair value reflects current market conditions (which reflect market participants', not the entity's, current expectations about future market conditions).

17. Relevance of Exit Price in Fair Value

An exit price of an asset or a liability embodies expectations about the future cash inflows and outflows associated with the asset or liability from the perspective of a market participant that holds the asset or owes the liability at the measurement date. An entity generates cash inflows from an asset by using the asset or by selling it. Even if an entity intends to generate cash inflows from an asset by using it rather than by selling it, an exit price embodies expectations of cash flows

arising from the use of the asset by selling it to a market participant that would use it in the same way. That is because a market participant buyer will pay only for the benefits it expects to generate from the use (or sale) of the asset.

Thus, an exit price is always a relevant definition of fair value for assets, regardless of whether an entity intends to use an asset or sell it.

Similarly, a liability gives rise to outflows of cash (or other economic resources) as an entity fulfils the obligation over time or when it transfers the obligation to another party. Even if an entity intends to fulfil the obligation over time, an exit price embodies expectations of related cash outflows because a market participant transferee would ultimately be required to fulfil the obligation.

Thus, an exit price is always a relevant definition of fair value for liabilities, regardless of whether an entity intends to fulfil the liability or transfer it to another party that will fulfil it.

18. Practical Challenges in Implementing IFRS 13

Key information related to the fair value accounting and disclosure can be described as

- measurement hierarchy,

- valuation techniques and

- inputs (Level 1, Level 2, and Level 3), and iv) quantitative information about significant unobservable inputs.

There are challenges in assessing whether a market is active, and whether an input is significant and observable, and they can lead to inconsistent classification within the fair value measurement hierarchy. Inconsistent assessment of whether a market is active can also lead to inconsistent fair value measurements because Level 1 inputs are used without adjustments, whereas Level 2 inputs can be adjusted.

Additionally, it is difficult to assess highest and best use (HABU) of the asset under consideration. Often, as a practical expedient, most assessments result in a conclusion that current use is the highest and best use.

Specific challenges arise when using third-party pricing, and when deciding whether assessment is quantitative or qualitative, or is at one point in time or over time. This may result in diversity in practice with respect to what is classified as Level 3 measurement.

There are challenges in measuring biological assets when there are no market inputs. These challenges arise mostly for growing produce, with differences arising in assessing when to start recognising growing produce and how to measure it, and in carrying out an overall assessment of whether the measurement is reliable.

19. The Myth

A perception that Level 3 measurements are less relevant to users of financial statements than Level 2 measurements, and that Level 2 measurements are less relevant to them than Level 1 measurements is a myth. Rather, fair value measurement across all levels of hierarchy is value relevant.

20. Presentation of Fair Value Hierarchy in Annual Financial Statements

Despite 2 years to successful adoption of Ind AS (Indian version of IFRS), entities are still confused as to hierarchy of fair value of few instruments such as preference shares (as an asset), embedded derivatives designated as cash flow hedge, and various financial liabilities. Following table presents acceptable and consistent application of hierarchical presentation of fair values of financial instruments.

₹ crore

Particulars	Note	As at 31-3-2019				As at 31-3-2018			
		Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
Financial assets:									
Investments at FVTPL:									
(i) Equity shares (other than those held in subsidiary & assosiate companies)	5	31.67	–	65.68	97.35	72.27	–	64.37	136.64
(ii) Preference shares	5	–	888.68	–	888.68	–	1085.08	–	1085.08
(iii) Mutual fund units	10	1631.69	–	–	1631.69	1070.80	–	–	1070.80
(iv) Bonds	10	656.38	–	–	656.38	424.46	–	–	424.46
(v) Derivative instruments not designated as cash flow hedges	7,15	–	9.84	–	9.84	–	3.77	–	3.77
(vi) Embedded derivative Instruments not designated as cash flow hedges	7,15	–	12.40	–	12.40	–	21.33	–	21.33

₹ crore

Particulars	Note	As at 31-3-2019				As at 31-3-2018			
		Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
Investments at FVTOCI									
(i) Debt instruments viz. government securities, bonds and debentures	10	2406.91	–	–	2406.91	2849.72	–	–	2849.72
(ii) Derivative financial instruments designated as cash flow hedges	7,15	–	602.52	–	602.52	–	358.49	–	358.49
(iii) Embedded derivative financial instruments designated as cash flow hedges	7,15	–	0.18	–	0.18	–	1.96	–	1.96
Total		4726.65	1513.62	65.68	6305.95	4417.25	1470.63	64.37	5952.25
Financial Liabilities:									
(i) At FVTPL - Designated as FVTPL:									
(a) Derivative instruments not designated as cash flow hedges	20,26	–	6.86	–	6.86	–	13.52	–	13.52
(b) Embedded derivative instruments not designated as cash flow hedges	20,26	–	3.26	–	3.26	–	15.79	–	15.79
(ii) Designated as FVTOCI:									
(a) Derivative financial instruments designated as cash flow hedges	20,26	–	234.05	–	234.05	–	132.19	–	132.19
(b) Embedded derivative financial instruments designated as cash flow hedges	20,26	–	91.54	–	91.54	–	121.34	–	121.34
Total		–	335.71	–	335.71	–	282.84	–	282.84

Valuation technique and key inputs used to determine fair value:

1. Level 1 : Mutual funds, bonds, debentures and government securities- Quoted price in the active market.
2. Level 2 : (a) Derivative instrument – Mark to market on forward covers and embedded derivative instruments is based on forward exchange rates at the end of reporting period and discounted using G-sec rate plus applicable spread.
   (b) Preference Shares – Future cash flows are discounted using G- sec rate plus applicable spread as at reporting date.

(Above example is from Annual Report of Larsen & Toubro for FY 2018-19)

21. Costs Involved in Annual Application of IFRS 13

Following disclosures relating to Level 3 fair value measurements are considered to be the most costly to prepare:

- reconciliation of changes in Level 3 fair value measurements (reconciliation);

- quantitative analysis of the sensitivity of Level 3 measurement to reasonably possible changes in significant unobservable inputs (sensitivity analysis);

- quantitative information about significant unobservable inputs; and

- information on unrealised gains and losses relating to Level 3 measurements.

Following Example illustrates above 4 points.

Movement of items measured using unobservable inputs (Level 3):

₹ crore

Particulars	Equity Investment in Tidel Park Limited
Balance as at 1-4-2017	55.94
Gains/(losses) recognised in Profit or Loss during 2017-18	8.32
Balance as at 31-3-2018	64.27
Gains/(losses) recognised in Profit or Loss during 2018-19	1.32
Balance as at 31-3-2019	65.58

Significant unobservable inputs used in level 3 fair value measurements and sensitivity of the fair value measurement to changes in unobservable inputs:

₹ crore

Particulars	Fair Value as at 31-3-2019	Fair Value as at 31-3-2018	Significant unobservable inputs	Sensitivity
Equity Investment in "Tidel Park Limited"	65.58	64.27	31-3-2019: 1. Net realisation per month ₹ 30.90 per sq/ft. 2. Capitalisation rate 12.25% 31-3-2018: 1. Net realisation per month ₹ 30 per sq/ft. 2. Capitalisation rate 12%	31-3-2019 : 1% change in net realisation would result in +/- ₹ 0.32 crore (post tax +/- ₹ 0.21 crore). 25 bps change in capitalisation rate would result in +/- ₹ 0.63 crore (post tax +/- ₹ 0.41 crore). 31-3-2018 : 1% change in net realisation would result in +/- ₹ 0.31 crore (post tax +/- ₹ 0.20 crore). 25 bps change in capitalisation rate would result in +/- ₹ 0.64 crore (post tax +/- ₹ 0.42 crore).

(Above example is from Annual Report of Larsen & Toubro for FY 2018-19)

22. A Unit of Accounting

Fair Value measurement guidance articulated in both ASC Topic 820 and IFRS 13 states: "An entity shall measure the Fair Value of an asset or liability using the assumptions that Market Participants would use when pricing the asset or liability, assuming that Market Participants act in their economic best interest."3 Neither ASC Topic 820 nor IFRS 13 specify the Unit of Account for assets or liabilities, but rely on other accounting standards to do so.

In US GAAP, ASC Topic 946 specifies that an Investment company must measure its Investments in debt and equity securities at Fair Value. An entity then refers to ASC Topic 820 for Fair Value measurement guidance. In the absence of more specific Unit of Account guidance from ASC Topic 946, entities measure the Fair Value of their debt and equity securities consistently with how Market Participants would act in their economic best interest.

One interpretation is that because IFRS 10 and IAS 28 refer to measuring Fair Value in accordance with IFRS 9, the Unit of Account is determined by IFRS 9 and is a single share. However, actual transactions for non-actively traded securities rarely take place on a single share basis. Another interpretation is that the Unit of Account is determined by IFRS 10, IAS 27 and IAS 28 as the "Investment", which is not necessarily a single share. This interpretation more fully matches how Market Participants transact. Practically, it is observed that unit of Account would be the entire interest if that is the basis upon which Market Participants would transact.

23. Fair Valuation in Unquoted Market – Venture Capital (VC) Series A, B, and C Funding

Some Funds/ VCs invest in multiple securities or tranches of the same Investee Company. If a Market Participant would be expected to transact all positions in the same underlying Investee Company simultaneously, for example separate Investments made in series A, series B, and series C, then Fair Value would be estimated for the aggregate Investment in the Investee Company.

If a Market Participant would be expected to transact separately, for example purchasing series A independent from series B and series C, or if Debt Investments are purchased independent of equity, then Fair Value would be more appropriately determined for each individual financial instrument.

24. Calibration – Tool for Valuers

Calibration is a powerful tool. It can assist in catching the impacts of control and Liquidity, among other inputs, on a Fair Value measurement.

Calibration in Relative Valuation

For illustrative purposes, assume an Investment is purchased at Fair Value at an implied 5x EBITDA multiple. At the time of purchase, comparable companies are trading at 7x EBITDA. When compared to the comparable companies, the 5x

entry multiple incorporates Liquidity, control, and other differences between the Investment and comparable companies. At future Measurement Dates, judgement would be applied to determine how to move the acquisition multiple of 5x in relation to changes in the multiple of comparable companies.

For example, if the comparable companies moved from 7x to 11x, the Valuer may conclude that the 2 turns of EBITDA difference at entry (5x vs 7x) should be maintained, resulting in a Fair Value estimate derived by applying a 9x multiple to the Investee Company's updated EBITDA. Similar judgements would be made using inputs for other Valuation Techniques. The Valuer would not automatically use the entry difference (2x) at future valuation dates, but would determine how much a Market Participant would be willing to pay for the Investment using the calibrated entry inputs as a point of reference.

Calibration in Income Based Valuation

The discount rate implied at acquisition can be deconstructed into its component parts based on the weighted average cost of capital, which will, in particular, provide a basis for a company specific risk premium, also known as alpha. The components of the weighted average cost of capital would then be updated at future Measurement Dates based on then current market conditions (with adjustments to the alpha based on company specific facts and circumstances) and applied to most likely cash flows at that point in time.

25. Application of Calibration in finding Acquisition Multiple Vs. Quoted Company Trading Multiple

Assume the acquisition price of an Investment was deemed Fair Value (e.g. an Orderly Transaction price) and represented an EBITDA multiple of 5 when comparable company EBITDA multiples were 8. In future periods, when estimating Fair Value judgement is required as to whether or not the 30% discount to comparable company multiples should be maintained or should change at each subsequent Measurement Date.

26. Backtesting – Current Fairness of Previous Fair Value

Valuers should seek to understand the substantive differences that legitimately occur between the exit price and the previous Fair Value assessment. Backtesting is the process of comparing an actual liquidity event (sale, IPO, etc.) to the most recently determined Fair Value estimate. When the valuation implied by an actual Realisation or liquidity event is compared to Fair Value estimates at the most recent Measurement Dates, the Valuer is provided with additional information to help assess the rigour of the Fair Value estimation process. This does not mean that the exit price should equal the previous Fair Value measurement, but should be used as an input to continuously improve the rigour of the Fair Value estimates. Over time, Backtesting provides the Valuer with a tool to assess whether there are inherent biases (e.g. overly conservative assumptions) built into the valuation process and thereby identify areas for potential improvement.

27. Using Industry Benchmarks

The use of industry benchmarks for valuation is only likely to be reliable and therefore appropriate as the main basis of estimating Fair Value in limited situations and is more likely to be useful as a sanity check of values produced using other techniques.

28. Conclusion

In an Indian context, Fair Value information enhanced the quality of analysts' earnings forecasts through improving forecasting accuracy, frequency, timeliness, and specificity level. It has also raised the quality of accounting information by improving its transparency, timeliness, reliability, comparability and, in particular, its relevance.