ED/AS113/2022/21

Exposure Draft

Accounting Standard (AS) 113

Fair Value Measurement

Issued by

Accounting Standards Board

The Institute of Chartered Accountants of India

General Comments:

1. Fair value is a basis of measurement that aims to increase the transparency of asset valuations, which in turn assists in providing investors with updated market related financial records on which decisions can be made The ED aim to increase the decision usefulness of financial information for users of the financial statements pertaining to fair value as a basis of measurement.

2. However, one of the basic question is that whether fair value Levels 1 and 2 measurements are more value relevant than Level 3 fair value measurements in a less-active market. Specifically, this requires to examine the value relevance of fair value measures for each disclosure level of fair value and to assess the impact of corporate governance on the value relevance of less observable fair value disclosures (Levels 2 and 3).

3. Fair value is disclosed using the three level hierarchy of fair value measurements. Level one is the most reliable measure as it only considers related market values, whereas level three
is the least reliable measurement since it only consists of management's estimates. Level two is a combination of related market values and management's estimates. Thus it is evident fair value as a basis of measurement increases users' decision usefulness and in essence the financial information provided is more relevant, but less reliable as it moves from level one to three.

4. The fact is that investors in a less active market value management inputs more than market information that are more transparent. Investors pay limited interest to corporate governance structures when pricing fair value measurement, implying that they rely on factors beyond corporate governance mechanisms. investors in less-active markets value management's inputs more than those of the market.

5. The fair value of assets level 1, 2 and 3, as well as the fair value of liabilities level 3 are value relevant while the fair value of liabilities level 1 and 2 are not value relevant. Furthermore, the market pricing of level 2 and 3 fair value assets and liabilities may not lower for companies with a high debt equity ratio than for companies with a low debt equity ratio. The pricing of level 3 assets may depend on financial crises or Global recessions.

6. Fair value assets across different hierarchy levels are value relevant. On the contrary, fair value liabilities are priced differently across the different hierarchy levels.

7. Fair value disclosures made should not be limited to disclosing the level of the three level hierarchy of fair value, especially when management's judgements and estimates predominately effect the fair value measurement made (level two and level three of the three level hierarchy). Additional disclosure should be required when level two and level three are used, detailing management's estimates and judgements. This will reduce the efforts to manipulate financial statements and increase the transparency, reliability and relevance of the usefulness of financial statements. The disclosures to be included should guide the financial statement user into identifying how the fair value measurement was derived at, which can then be evaluated by users of the financial statements.

8. Further, the main impediments to the implementation of FV accounting are:
• high difficulty in obtaining FV information
• shortage of FV-related technical knowledge and professional judgement skills among accountants
• high costs and complexity of measuring FV
• effect of FV adoption on earnings volatility
• imperfect accounting standards and insufficient guidance on the application of FV
• imperfect supporting systems and facilities.

9. Thus the need is to:

- Provide more typical cases and greater operational guidance on the operation of FV accounting

- Perfect factor markets and build authoritative data platforms in order to overcome one of the most important challenges encountered in the implementation of FV.

- Improve the quality of information disclosure. FV information should be more fully and timely disclosed in the notes to financial statements, particularly Level 3 FV information including the models, methods, assumptions, parameters, etc for estimating FV. There should also be more rigorous enforcement over the requirements surrounding the quantity and quality of FV disclosure.

- Build authoritative data platforms

- Lift the quality and quantity of FV-related information disclosure

- Improve relevant regulations relating to companies, asset appraisers and external auditors. Companies use FV accounting to manage earnings by opportunistically choosing the FV model and selecting methods, assumptions, and particularly parameters for estimating FV. Hence, it is important to enhance the supervision over the use of FV accounting, especially when managers have discretions.

10. Given the high complexity of FV accounting and the lack of FV-related technical knowledge, company managers largely depended on the work of external asset appraisers. However, managers may have strong incentives to negotiate with these hired asset appraisers. Therefore, the professionalism and independence of such asset appraisers is crucial to maintaining the high quality of FV information. Similarly, external auditors can play an important role in overcoming the difficulties and challenges in the process of implementing FV accounting and improving the quality of FV information, but this requires auditors to strengthen up their professional competence and independence.

11. Today's world economy requires greater use of fair value measurements in financial reporting because it is perceived that fair measurement information is more relevant to investors than

historical cost information. It is argued that moving in this direction will reduce the complexity of accounting rules and consequently increase transparency in financial reporting. The objective of fair value measurement is for firms to estimate qualitatively determine operating prices based on current information and conditions. To meet this objective, firms need to fully incorporate current information about future cash flows and current risk-adjusted discount rates into their fair value measurements.

12. However, the reliability of the fair value measurement depends on the availableness of an active market. For the developed countries, fair value accounting is considered as a good measure to present more reliable financial information. In the developing countries, the question of active market is a major concern.

13. The benefits of fair value accounting there is derivable if organisations prepare financial reporting using the mixture of fair value accounting and historical value accounting. The investors want fair value information so as to better determine the true value of their investment while they also wish to see the historical cost information that provide a measure of cash flows. This indicates whether management has achieved operating results that were budgeted for.

14. One of the moot question I that whether the fair value definition in the ED is able to effectively enhance transparency and comparability of accounting data, especially when private equities are not held for trading purposes. Assessing private equity fair values using market-based valuation techniques misleads performance analysis and appraisals as well as management choices and compensation and it also alters comparison among financial reports. Value creation largely varies depending on the selected valuation technique. Estimation errors bear important economic consequences. They increase volatility in accounting data, which – in turn - have important effects on bank capital requirements and real economy financing. For this reason, the real capability of ED conduces to the public good should be further investigated.

15. Different valuation techniques provide very different fair values which can alter comparison among financial reports, mislead performance analysis and appraisals as well as management choices and compensation. Value creation largely varies depending on the selected valuation technique. The reliability of valuation techniques depends on fair values that faithfully reflect the real world economic phenomena. This issue is particularly critical for market and transaction multiples which are categorised by ED within Level 2 inputs as they are supposed to be highly unbiased. Exit price does not suit the evaluation of private equities held with a strategic intent because they are not held for capital gain purposes as they are part of long-term investments devoted to exploit business opportunity or relationship, with no expectation of any capital gain. While the objective of a fair value intended as an exit price is to make financial statement more transparent, it is also clear that such an exit price does not necessarily reflect the manner in which cash flows

associated with an asset is realized. For instance, evidence shows that the performance of private equities is relatively different from publicly traded companies. Hence, using market multiples – which are categorised within Level 2 inputs as they are supposed to be highly unbiased - and transaction multiples for evaluating private equities held with a strategic intent is misleading. Fair value of private equities should be assessed taking into consideration the opportunities actually available to the specific entity and not according exit price.

16. SIRC of ICAI agree that the disclosure objectives would help entities, auditors, and regulators to determine the information provided in the notes and will meet the overall user information needs. However, we acknowledge that the basis of disclosures is based on what is specific to an entity and important to management and the remaining users of the financial statements in the context of the industry that each entity operates in. However, the implementation of the overall disclosure objective would be different as entities operate in unique environments which would result in entities having a unique sets of disclosures which might potentially compromise comparability. The ED therefore should consider comparability of general purpose financial statements. At the same time the ED would not achieve comparability in respect of industry specific requirements such as auditors, companies. For example, if an item is not material in the current year and in the following year the item becomes material and needs to be disclosed in the financial statements, how do we achieve comparability given such a scenario? What is important to management should be the basis of disclosure i.e. by ensuring that what is disclosed is relevant and faithfully represents that what it purports to represent, once judgement has been assessed thoroughly.

17. There would be more work for entities when preparing their financial statements in providing the specific disclosures. Preparers/entities may produce high volumes of documents justifying their judgments so that auditors have evidence when verifying their judgments. Documents proving decisions made by management are correct will need to be prepared and provided in making sure immaterial information is not provided. This exercise would also bring additional costs to the entities.

18. Specific disclosures would encourage preparers to tailor their disclosures, provide explanations and to ensure that relevant information is provided in the financial statements. However, it would be difficult to advise/comment on whether the specific disclosure objectives would eliminate the irrelevant information. It is not clear how the ED classified items as mandatory and others as non-mandatory; therefore, this classification be done away with as preparers might overlook information the ED has classified as non-mandatory which might in fact be relevant to the preparers. The preparers should determine which disclosures to include, based on materiality in terms of AS guidance as well as what is most meaningful based on judgement and thorough assessments. Non-mandatory disclosures are likely to come across as voluntary because entities would choose whether to disclose the information or not. We also believe that the approach of including the non-mandatory disclosures will lead to entities to continue with the checklist approach. Therefore, we would like the ED to clarify how they decided on certain disclosures to be mandatory and

other disclosures to be non-mandatory. The control approach through documentation of the process, the judgement and the decision taken by the entity would assist the auditors in determining whether the entity has applied judgements effectively. However, this would also bring more work on auditors and regulators.

19. The ED should focus more on the statement of profit or loss rather than the statement of financial position when they develop the overall approach to improve the disclosures.

20. The ED should provide guidance/ clarity on how they decided on this proposed specific disclosure objective and how these proposed specific disclosure objectives meet the user needs.

21. The proposed specific disclosure objective for assets and liabilities not measured at fair value in the statement of financial position but for which fair value is disclosed in the notes would be burdensome to the preparer. This proposed specific disclosure objective would incur additional costs.

The following insertions are suggested in the ED:

Objective

1. (a)…

   (b)…..

   (c) ……….

   (d) to provide explanations and application guidance for the determination of fair value.

6. AS 113 Fair Value Measurement applies to AS that require or permit fair value measurements or disclosures and provides a single AS framework for measuring fair value and requires disclosures about fair value measurement. The Standard defines fair value on the basis of an 'exit price' notion and uses a 'fair value hierarchy', which results in a market-based, rather than entity-specific, measurement.

7. The objective of a fair value measurement is to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions. A fair value measurement requires an entity to determine all of the following:

a. the particular asset or liability that is the subject of the measurement (consistently with its unit of account)
b. for a non-financial asset, the valuation premise that is appropriate for the measurement (consistently with its highest and best use)
c. the principal (or most advantageous) market for the asset or liability
d. the valuation technique appropriate for the measurement, considering the availability of data with which to develop inputs that represent the assumptions that

market participants would use when pricing the asset or liability and the level of the fair value hierarchy within which the inputs are categorised.

A few factors that actually encourage the implementation of FV accounting, includes:

a. a desire to manage earnings or market values
b. the need to meet regulatory requirements
c. the drive to improve the quality of accounting information
d. a perception that FV more reliably reflects the value of the assets and liabilities

Scope

21 A

Some of the key factors and risks to consider when measuring fair value using a valuation technique include the following.

Economic activity levels. The effects of pandemic or recession on different sectors of the economy may vary significantly – e.g. companies in the transportation and leisure sectors continue to be more adversely affected than the technology and telecommunications sectors in a pandemic.

Credit risk and liquidity risk. The uncertain economic environment may result in increases in credit risk and liquidity risk for some companies. Own credit risk and/or counterparty credit risk used as inputs into valuation techniques may therefore increase.

Forecasting risk. Fair value measurements should reflect the greater uncertainty in making economic and financial forecasts in the near term, due to the difficulty in forecasting the magnitude and duration of the economic impact due pandemic . recession etc., Companies need to be wary of anticipating economic recovery too soon in their cash flow forecasts given the prolonged nature of the pandemic.

Foreign exchange risk. Companies with significant sales or purchases in foreign currencies may be adversely affected by exchange rate movements.

Commodity price risk. Companies in extractive industries may be significantly affected by decreases in the prices of certain commodities.

Measurement

22. A fair value measurement is a market-based measurement based on an exit price notion and is not entity-specific. Therefore, a fair value measurement must be determined on the basis of the assumptions that market participants would use in pricing an item, regardless of whether those assumptions are observable or unobservable. A measurement based on "true value," "economic value," or management's perception of value is not consistent with a fair value measurement. The fair value hierarchy in ED serves as a basis for considering market-participant assumptions and distinguishes between:

-Market-participant assumptions developed on the basis of market data that are independent of the entity (observable inputs), and;

- An entity’s own assumptions about market-participant assumptions developed on the basis of the best information available in the particular circumstances, including assumptions about the risks inherent in inputs or valuation techniques.