

VIEW AND COUNTERVIEW



FAIR VALUE: SHOULD WE FEAR THE FAIR VALUE?

Fair Value accounting is now strongly entrenched in the accounting cannons after centuries of following historical cost convention. It is a shift from ENTRY perspective to EXIT perspective. Historical cost convention was perhaps the premium for stability and long-term prudence, to cover the business from volatility of business and market forces. That idea of measure of value – based on original cost – was replaced by a measure defined as exchange value (of an asset) between knowledgeable and willing parties in an arm's length transaction.

Does fair value (FV) inform the user of financials better? Does it improve upon true and fair consideration? Are users happy to pay the price of volatility to get the 'real' picture? REALITY, what actually happened, has been the central pillar accounting for centuries. FV, in a lighter vein could be augmented or virtual reality which only time will test.

This fourth VIEW and COUNTERVIEW aims to tell the story of how fair the fair value is and although it has had a bumpy ride in times of turbulence, it is now an accepted norm of accounting.

VIEW: WHY FAIR VALUE SHOULD NOT HAVE FEARED VALUE?

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Fair value accounting is an integral aspect of Ind AS and all other global standards, such as IFRS or US GAAP. Since Ind AS has been in use for more than two years now, a discussion on this topic is probably only academic. Most entities reluctantly or otherwise have accepted this concept, though the debate when it was first introduced was highly exacerbated. Of course, in good times, everyone likes fair value accounting, however, in bad times they will be complaining.

Some argue that fair value accounting is procyclical and caused the credit crisis a few years ago. However, subsequent research done by SEC indicates that financial institutions collapsed because of credit losses on doubtful mortgages, caused by sub-prime lending, and not fair value accounting. Fair value accounting was rather useful in highlighting the inherent problem and weaknesses of entities.

Those criticising fair value accounting do not seem to provide any credible alternatives. Do we take a step back to historical cost accounting, wherein, financial assets are stated at outdated values and hence not relevant or reliable? Is there any better way of accounting for derivatives, other than using fair value accounting? For example, in the case of long-term foreign exchange forward contracts there may not be an active market. For such contracts, entities obtain MTM quotes from banks. In practice, significant differences have been observed between quotes from various banks. Though fair value in this case is judgemental, is it still not a much better alternative than not accounting or accounting at historical price?

Some years ago, an exercise was conducted by a global accounting firm to determine employee stock option charge. By making changes to the input variables, all within the allowable parameters of IFRS, option expense as a percentage of reported income was found to vary as much as 40% to 155%. However, since then valuation guidance on fair value measurement has been issued by IASB and International Valuation Standards Council (IVSC), and overtime subjectivity and valuation spread reduced substantially.

The next question is what kind of assets and liabilities lend themselves better to fair value accounting. Whilst many non-financial assets under Ind AS are accounted at historical cost, biological assets are accounted at fair

value. Unfortunately, many biological assets are simply not subject to reliable estimates of fair value. Take for instance, a colt, which is kept as a potential breeding stock, grows into a fine stallion. The stallion starts winning race events and is also used in Bollywood films. The stallion earns substantial amount for its owner from breeding and other services. The stallion gets older, his utility decreases. Eventually, the stallion dies of old age and the carcass used as pet food. At each stage in the life of the horse, the fair values would change significantly, but estimating the fair values could be extremely subjective, difficult and make earnings highly volatile. In many ways, the stallion reminds one of fixed assets. Changes in fair value of fixed assets are not recognised in the income statement, then why should the treatment be different in the case of atleast some biological non-financial assets? Certainly, an invariable application of fair valuation is not what the author recommends.

In India, the debate on fair value has got confused because of lack of understanding of Ind AS. For example, a common misunderstanding is that all assets and liabilities are stated at fair value. However, the truth is that under Ind AS many non-financial assets such as fixed assets or intangible assets are stated at

cost less depreciation (unless an entity chooses to apply the revaluation model, subject to conditions being fulfilled). The apprehension of using fair value accounting is driven by tax considerations or legal legacy. However, one may note that Ind AS financial statements are driven towards the needs of the investor and not of any regulator. Therefore, the income-tax and other regulatory authorities should ensure that Ind AS is tax or statute neutral.

Determining fair value can be extremely excruciating in certain cases, such as biological assets, contingent liabilities, unquoted equity shares, *etc.* Notwithstanding the difficulty, determining fair value should not be an excuse for abandoning the idea of fair valuation. Doing so would be throwing the baby with the bath water. Fair valuation cannot be expected to provide, the same result if different valuers were valuing it. This is because fair valuation is not a science but an art and no guidance or methodology can ever make it a science. IFRS 13 (Ind AS 113) and the IVSC valuation standards were certainly helpful in bringing about clarity, consistency and in collapsing the valuation spread between valuers.

In the examples below, it is hard to imagine, a measurement basis other than fair value.

| S.No. | Particulars | Indian GAAP | Reason for fair value under Ind AS |
|-------|---|---|--|
| 1 | Investment in equity and debt mutual funds | Long-term investments are carried at cost less provision for other than temporary decline in the value of investment, if any. | Under Ind AS 109, Investments in debt and equity mutual funds are measured at fair value with changes credited or debited to P&L (FVTPL). This makes absolute practical sense. Both retail and corporate investors evaluate their investment in equity and debt funds (other than FMPs) on the basis of its fair value and not historical cost. Even ordinary investors will consider historical cost as being an outdated measure. |
| 2 | Investment in equity shares (quoted and unquoted) | Long-term investments are carried at cost less provision for other than temporary decline in the value of investment, if any. | The reasons discussed in (1) above equally applies to investment in equity shares (quoted and unquoted). Some companies were against fair value in the case of investments in unquoted shares. However, Ind AS implementation has revealed that in many cases unquoted equity shares were either impaired or had a very high valuation. Accounting at fair value will reflect the real value of the shares and the entity that holds such shares. Such information is absolutely critical for any reader of financial statements, for making a sensible assessment of the true worth of an entity. |
| 3 | Investment in debt instruments | Carried at amortised cost by banks and financial institutions. Other entities carry Long-term investments at cost less provision for other than temporary decline in the value of investment, if any. Interest is recognised on accrual basis at contractual rate. | Such investments if they meet certain conditions are accounted on an amortised cost basis. However, the fair value disclosure with respect to such instruments is required. Factors such as change in interest rate, credit rating, inflation rate, <i>etc.</i> plays an important role in determination of fair value disclosure with respect to such instruments is required. Factors such as change in interest rate, credit rating, inflation rate, <i>etc.</i> plays an important role in determination of fair value. |

| S.No. | Particulars | Indian GAAP | Reason for fair value under Ind AS |
|-------|--|---|--|
| | | | <p>Consider an example on why fair value disclosure of loans given by a financial company is critical to understanding the financial position of the entity.</p> <p>Example: A finance company gives loan at competitive rates let say @ 8% and subsequently interest rate goes up; say 10%. Fair value of the loan is impacted significantly, resulting in a huge hair cut (but not under Indian GAAP). Further, an entity may have liability at floating rate, so there is clear mismatch between assets and liabilities, which will impact its future profitability and viability. This will get reflected under Ind AS but not under Indian GAAP.</p> |
| 4 | Interest free loans between parent and subsidiary | Both parent and subsidiary recognise loan at amount paid/received. | On day 1, the parent will recognize loan at fair value and debit the differential amount to investment in subsidiary. Subsequently, interest income is recognised in P&L at market rate. The subsidiary will also recognise loan at fair value and credit differential amount to capital reserve (investment by parent). This will result in interest expense recognition at market rate. Some may argue that this is notional accounting. However, this accounting will reveal the hidden cost in the group transactions. Further, it will eliminate transaction structuring by treating all loans whether interest bearing or non-interest bearing equally for accounting purposes. It will also bring transparency in related party transactions. |
| 5 | Redeemable and convertible instruments, for example, redeemable or convertible preference shares | Instrument is accounted for based on their legal form. Redeemable and convertible preference shares are presented as equity share capital | Redeemable preference share is treated as a liability. Convertible preference shares are split into equity and liability or derivative and liability. Fair value principles are applied in split accounting in case of convertible instruments and in determining the fair value of liability and interest expense. This, will fairly present the amount of liability and embedded equity/derivative. |
| 6 | Share based payment | Gives an option to account for ESOP expenses using either the fair value or the intrinsic value method over the vesting period. | It requires expenses of share based payment to be measured using the fair value method only. The fair value of an ESOP is estimated using an option pricing model like the Black Scholes Merton or a Binomial Model. Under Indian GAAP, very often the intrinsic method did not result in any ESOP cost for an entity. This is undesirable, since it makes a distinction between remuneration that is paid in cash vs that which is paid through an ESOP scheme. The form in which remuneration is paid should not determine the expense charge to the P&L. |
| 7 | Foreign Parent issues ESOP to employees of Indian subsidiary (there is no settlement obligation on subsidiary) | The parent generally recognizes ESOP expense and no expense is recognised by the subsidiary. | The expense will need to be recognised by subsidiary since its employees are receiving remuneration by way of ESOP. No expense can be recognised by the parent. Who provides the ESOP is not relevant to this assessment; rather, who receives the benefit is relevant. Fair value principles are applied in determining the ESOP cost. |
| 8 | Acquired contingent liabilities in business combination | Contingent liabilities do not form part of acquisition accounting. | The acquired contingent liabilities are recognised at the acquisition date at fair value, provided it can be measured reliably. By putting a value to contingent liabilities, the consequential goodwill amount is fairly reflected. |
| 9 | Sales Tax deferral/loan | Sales tax loan is accounted for at the undiscounted value. | Ind AS requires that on initial recognition, sales tax loan should be accounted for at fair value, i.e., present value of future cash flows. Difference between amount deferred and fair value of loan is correctly treated as government grant under Ind AS 20. Sales tax loan is a funding by the government to an entity. Ind AS accounting truly reflects that underlying substance. |

In many areas, fair valuation is simply inevitable. Fair value accounting does not create good or bad news; rather it is an impartial messenger of the news.

COUNTERVIEW: WHEREFORE FAIR VALUE?

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A common misconception is that **wherefore** means *where*; it is occasionally so used in retellings of Romeo and Juliet — often for comedic effect. The meaning of “*Wherefore art thou Romeo?*” is not “*Where are you, Romeo?*” but “*Why are you Romeo?*” i.e. “*Why did you have to be a Montague*”ⁱ (the family name of Romeo).

One may wonder, why in an article that is meant to be defiant to current trends of accounting I am quoting Shakespeare. Well, the fact remains that English as she is spoken is not necessarily understood in the same manner by everyone. That is the bane with Fair Value (FV) accounting too. My concept of FV could be different from your concept. Hence, the users of financial statements could possibly, get different perspective of financial statements. Accounting permits or requires (based on specific conditions) different bases of measurement. The two main bases are historical cost and current value, with current value having bases such as FV, value in use for assets or fulfilment value for liabilities and current cost. The IASB in March 2018 has issued the revised *Conceptual Framework of Financial Reporting*. Chapter 6 describes various measurement bases and discusses factors to be considered when selecting those. Our Indian Accounting Standards (Ind AS) will need to follow this framework.

It is said that double entry book keeping was first codified in a treatise 1494 in by Luca Pacioli. Prior to that, there are records of double entry book keeping by Jews and Koreans. The Bahi-Khata system of accounting in India was prevalent too. These would have been times when traders of different regions and languages did business with each other and to settle the trades needed a uniform language of accounting acceptable to all. Double entry system of book keeping served the purpose. Trade practices, technology and methods of transacting evolved but the cardinal rules of accounting remained the same. Ever since Pacioli’s treatise those rules (debit what comes in, credit what goes out, et al) have remained consistent for more than 600 years!

Twentieth century saw multiplication of world trade;

ⁱ <https://en.wiktionary.org/wiki/wherefore#English>

money becoming more fungible, businesses regulated, stakes increasing, higher gains, deeper losses. This led the users of financial statements question accounting and financial statements. The persons who were making decisions of providing resources to an entity relied on the financial information that was available and they realised that the financial information was inadequate – if an entity had acquired an asset fifty years ago and it was carried at historical cost less depreciation, then that information was not relevant to the user who wanted to take a decision of providing resources. These decisions were made on an elaborate combination of what price a similar asset / business fetches in an open market and / or a calculation of future cash flows, discounted at an appropriate rate reflecting the risk of the entity i.e. at FV. However, accounting continued on historical cost measurement basis.

Since 1980s there was a demand to have the needs of resource providers addressed in the financial statements. Consequently, the concept of FV gained prominence and eventually accounting standards included it and the concept of *exit price* emerged. Along with that came in the complex arithmetical computations, statistical assumptions & probabilities requiring use of significant estimations.

India is in the process of converging to IFRS since April 2016 in a phased manner. The entities that are applying Ind AS are of different sizes and structures even amongst listed entities The experience of two years of Ind AS of preparers and auditors has been educating as well as exasperating. The questions that promoters and many preparers ask of accountants and auditors are:-

- ◆ Why my entity needs to be evaluated on an “exit price”.
- ◆ Am I selling my entity as on the balance sheet date?
- ◆ What has happened to the concept of going concern?
- ◆ My balance sheet used to be prepared for me and my shareholders and my bankers and my business partners and they know how healthy or otherwise I am.
- ◆ By having my financial statements at an exit price am I telling the world that my business is up for grabs at the values presented in the financial statements?

◆ I do not want to and I have no intentions of selling my business, either in parts or as a whole, then why should I increase my costs of compliance by undertaking valuation exercises based on various inputs that standards themselves say can be “unobservable” So, by definition they are abstract and unreal.

◆ So am I placing a picture of my state of affairs based on presumptions, statistics and estimations rather than at the values at which the transactions have taken place?

Answers anyone?

The standard gives a three level hierarchy for specific facts and circumstances. The hierarchy ranges from simple to complex calculations. An entity is required to replicate the above at each measurement date. If it is presenting financial results on quarterly basis, then all these steps have to be done each quarter. The cost of compliance with FV computations, recognition and measurement is indeed significant. Not to mention the volatility that can enter the financial statements. If the markets are erratic then it would get reflected in the financial statements. Compare this with the stability provided by historical cost measurement, where one is certain that the amounts at which assets and liabilities are presented are the values that are a result of transactions that have already occurred.

One typical example of the complexity of FV accounting is the interest free or concessional interest loans given to employees. An entity is required to determine the FV of such loans, by discounting the cash flows at an appropriate rate of interest and documenting the rationale of appropriateness and then presenting the difference between the FV of the loan and the amount of loan as employee benefits and which would be recycled over the tenor of the loan, making it PL neutral over multiple years. When one explains this to business owner the reaction is flabbergasting. When one explains the rationale of this charge, then there is a reluctant nodding of head followed by, *“but when I gave the loan, this was not my intention. Sometimes the intent was to keep my employees satisfied and that cannot be an accounting rule / requirement”*. He reacts by saying, *“for me it is the amount of loan to employee that is critical – on employee leaving the organization I will recover the absolute amount and not its fair value.”*

If a simple business transaction of loan to employee causes such difficulties in FV accounting, one can only imagine what could be the case in complex business transactions.

Some standards require disclosure of FV of items that are carried at amortised cost! This defies logic to some preparers as the business model permits those items to be carried at amortised cost but disclosure requirements requires determining FV, implying going through the grind of estimations & computations and justifying it to all users of financial statements.

The user now has to read the voluminous disclosures to understand the impact of the numbers in the financial statements. Will they have the expertise of understanding the devil in such detailed? Isn't it fine that an entity provides such detailed information on a need to know basis, sat, to a potential investor to whom “FV at exit price” is more relevant rather than “historical cost”

The reaction of other stakeholders & users of financial statements viz. bankers, lenders, vendors, current & potential investors, tax authorities is awaited to be seen in public domain. Reactions and responses of users of financial statements and their impact on businesses will tell us whether FV accounting has achieved what it had set out to; whether the benefits indeed exceeded the costs. Only then, perhaps, we will know the answer to *wherefore art thou fair value accounting?*

India is part of a global business community and standards of performance have to be comparable. Hence, India decided to converge with IFRS. But, is it fair that every Indian entity that is not comparable with an international entity in terms of size and structure is required to go through this grind of fair value and its disclosures? Can one not look at a model of the IFRS for SMEs? For less complex entities IFRS for SMEs give limited options w.r.t recognition & measurement principles and disclosures are significantly less too. It would make the financial statements more relevant and reliable.

It has taken the world six centuries to move from historical cost measurement bases to FV measurement bases. We all experience that lifecycle of new technologies is much short lived. Likewise, can we equate FV as new technology prone for obsolescence a decade or five from

now? And thereafter do we move to a new technology or do we revert to historical cost.

An alternate proposition would be that only those entities that frequently raise resources from local and international markets, who have international investors, who have a mass that matters or are comparable with the Fortune Global 500ⁱⁱ can be required to have FV accounting. To understand where India stands, we have only 7 companies in this global list with the highest at 168th position. The 500th company on the global list has revenues of US\$ 21,609 Mnⁱⁱⁱ (INR 1,44,780 Crore). It would be worthwhile to do an analysis around this figure and determine what would be the right size for an entity to get involved in determination of FV and recognizing it in its financial statements. For others (*excluding sectors such as banking, insurance & lending*), historical cost could continue. FV will be need-based information, not necessarily part of financial statements.

ii <https://timesofindia.indiatimes.com/business/india-business/40-of-fortune-500-companies-asian-india-has-7-in-list/articleshow/59707630.cms>

iii <http://fortune.com/global500/list/>

iv <http://www.shakespeare-monologues.org/monologues/612>

One size fits all is a good dictum. However, if the size of an average Indian business entity that applies FV accounting is much smaller than the average size of a global entity that applies FV accounting, aren't we justified in having something simpler commensurate with our size and nature of business?

This debate shall certainly not end with this article but may at the least trigger a thought process, and for that I would like to end with apologies to William Shakespeare by a bit rephrasing of Marallus speaking to two rejoicing commoners in Julius Ceaser, Act 1, Scene 1^{iv} :-

Wherefore rejoice

What conquest brings fair value home?

What levels of hierarchy follows him to the statement of financial position to grace in probability weighted estimates

You measurement blocks, you recognition principles, you worse than senseless disclosure requirements

Oh you hard hearts, you cruel men of accounting

Knew you not historical accounting. ■