

# K C Mehta & Co.

Chartered Accountants

## *kcm*Guide

Indian Accounting Standards

**A tryst with Ind AS 113**  
"Fair Value Measurement"

January 4, 2021

## Background & Coverage

Fair Value concept is the cornerstone of Indian Accounting Standards (Ind AS). The Ind AS, at various places and situations, require the entity to recognise and/or measure the assets and liabilities at their fair values. Ind AS 113 is the Standard which provides guidance to the entity to determine fair values whenever any other Ind AS requires fair value accounting and/or its disclosures. Hence, this Standard is applied when the entity is required to, or opts to, use fair value.

In this paper, we have offered insights, through FAQs, on the following concepts and requirements as enunciated in Ind AS 113, in a simplified and practical manner:

### Core Concepts

Non-Financial Assets

Financial Liabilities and Own Equity Instruments

Fair Valuation Techniques

Fair Value Hierarchy and Inputs

Other Issues



### 1. What is fair value?

Fair Value 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 measurement date. Fair Value is based on exit price concept, rather than entry price concept.

Fair Value assumes that a transaction will take place in principal market or in absence thereof, in most advantageous market. It is not necessary that the transaction in the market for entity's own asset or liability should actually take place.

Further, the transaction:

- should be an orderly transaction, as opposed to a forced transaction or a distressed sale; and
- between the market participants, i.e. parties independent of each other, being knowledgeable and having reasonable understanding and having ability and willingness to enter into the transaction.

It is determined as on a specific date, known as measurement date, and the transaction is deemed to take place on that date. Fair value is based on the market conditions existing as on the measurement date.

If there are any specific circumstances relating to the asset, e.g., condition and location of the asset, restrictions, if any, on the sale and use of the asset, and it is evident that market participants would consider these aspects while pricing the transaction, then these circumstances shall be taken into consideration while fair valuing the asset or liability.

### 2. There might be various markets in which there could be a possibility to undertake the transaction. While calculating fair value, which market is deemed to be the market for the transaction?

Various markets may exist for the same asset or liability. It gives rise to the question which market shall be considered for the transaction.

Default assumption: the transaction takes place in principal market for that asset or liability (market with greatest volume and level of activity for the asset or liability).

If there is no principal market: the transaction shall be assumed to occur in the most advantageous market (market that maximizes the value of asset or minimizes the amount payable to settle the liability, after considering transaction and transportation costs).

Summary: if principal market exists, the transaction shall be considered to take place there, even if the price in another market is potentially better at the measurement date. In other cases, the transaction shall be considered to take place in most advantageous market.

### 3. What are transaction costs and transportation costs in relation to the asset or liability being fair valued?

Transaction Costs:

- costs that are directly attributable to the disposal of the asset or liability;
- result directly from and are essential to that transaction; and
- would not have been incurred by the entity if the transaction did not take place.

The price in the principal or most advantageous market shall not be adjusted for transaction costs for calculating the fair value. Transaction costs shall be accounted for under other applicable Standards.

#### Transportation Costs:

- costs that would be incurred to transport the asset from its current location to its market. If the location is the characteristic of the asset, the price shall be adjusted for the costs that would be incurred to transport the asset from its current location to that market.

Fair Value = Transaction Price in the Relevant Market, Less Transportation Costs.

As stated above, the transaction costs are not deducted while calculating fair values. However, for the limited purpose of ascertaining “most advantageous market”, both – transaction costs and transportation costs are deducted. Example:

Particulars	Market A (₹)	Market B (₹)	Market C (₹)
Transaction Price (A)	100	105	108
Transaction Cost (B)	4	2	5
Transportation Cost (C)	5	7	8
<b>Net Receipts (D = A - B - C)</b>	<b>91</b>	<b>96</b>	<b>95</b>
<b>Fair Value (E = A - C)</b>	<b>95</b>	<b>98</b>	<b>100</b>

For determining the most advantageous market, both the costs will be deducted from the transaction price.

It can be observed from the above table that Net Receipts is highest in Market B (i.e. ₹ 96), which makes it the most advantageous market.

Now, fair value will be Transaction Price less Transportation Costs in Market B, i.e. ₹ 98. It is pertinent to notice that even though the fair value in Market C is higher, the fair value prevailing in Market B is to be considered as the net receipts from Market B is higher. This holds good only for most advantageous market and not principal market.

#### 4. At what level, the fair value needs to be measured i.e., on standalone asset or liability level, or on group of assets or liabilities level?

The fair value can be measured either on a standalone asset or liability or on a group (i.e. group of assets and/or liabilities) level, as the case may be.

The level at which the asset and/or liability is aggregated and disaggregated for recognition purposes is known as “unit of account”. It is determined generally as per Standard that requires or permits the fair value measurement.

To mention a few examples, unit of account could be:

- an entire business, say Cash Generating Unit (CGU) or discontinued operation (Interesting thing to note is that it is possible that fair value of the business or CGU might be different from the sum of fair values of individual assets and liabilities); or
- standalone asset, say (i) each investment property; (ii) investment in subsidiary, associate, or joint venture,

individually; (i.e. each of these assets would be independent unit of account); or

- group of assets and/or liabilities, say the assets and liabilities with offsetting risks on the basis of net exposure to credit or market risk. For example, where the entity has receivable for goods supplied and payable for services availed from the same counterparty, both entities may agree to settle the transactions on net basis. With such offsetting arrangement, both entities virtually eliminate the credit risk associated with each counterparty. In such scenario, the entire group (i.e., financial asset and financial liability) will be single unit of account.

## 5. Is this Standard applicable in all situations where fair values are required?

No, the measurement and disclosure requirements of Ind AS 113 do not apply to the following situations:

- share-based payments within the scope of Ind AS 102, *Share-based Payments*;
- leasing transactions accounted for under Ind AS 116, *Leases*; and
- measurements which have similarities to fair values but are not fair values, e.g. net realizable value under Ind AS 2, *Inventories*, value-in-use under Ind AS 36, *Impairment of Assets*.

There are couple of additional situations where the measurement requirements of the Standard apply but disclosure requirements of the Standard do not apply:

- plan assets measured at fair value under Ind AS 19, *Employee Benefits*; and

- assets for which recoverable amount is fair value less costs of disposal under Ind AS 36, *Impairment of Assets*.

## 6. How are net realizable value and value-in-use different from fair value?

### Net Realisable Value:

- It is used in Ind AS 2 in valuation of inventories.
- It is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.
- It is the price at which the entity expects to actually sell the inventory, while fair value is the price at which market participants would generally trade the asset on rational basis i.e. in orderly transaction.
- The NRV is entity specific whereas the fair value is not.

### Value-in-use:

- It is used in Ind AS 36 in making the evaluation for impairment of assets.
- It is the present value of the future cash flows expected to be derived from an asset or cash-generating unit.
- It can differ from fair values, as it is not necessary that fair value (price at which market participants would generally trade the asset in orderly transaction) is exactly equal to discounted cash flows.

E.g., a cash generating unit can have fair value higher than its discounted cash flows due to goodwill premium.

**7. How is fair value calculated for non-financial assets?**

Fair value for non-financial assets is calculated on basis of the *highest and best use* of the asset.

Highest and best use is the use of a non-financial asset, by a market participant, that would maximize the value of the asset or the group (e.g., a business) within which the asset would be used or through a sale to another market participant. The highest and best use takes into account the use of the asset that is physically possible, legally permissible, and financially feasible.

- A use that is physically possible, takes into account the physical characteristics of the asset (e.g., the location or size of a property).
- A use that is legally permissible takes into account any legal restrictions on the use of the asset (e.g. the zoning regulations applicable to a property).
- A use that is financially feasible takes into account whether the use of asset generates adequate income or cash flows (after considering the costs of converting the asset for that use).

The highest and best use is determined from the perspective of market participants, even if the entity intends a different use i.e. the intent of an entity is not the criteria to determine highest and best use. It is the perspective and assumptions of market participants that needs to be taken into consideration for the determination of highest and best use.

**8. Whether highest and best use for the asset shall be on a standalone basis or in combination with other assets and liabilities?**

The highest and best use for a non-financial asset can be on (a) standalone basis; (b) in combination with other assets as a group; or (c) in combination with other assets and liabilities.

Standalone 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.

Combination with other assets and/or liabilities:

- The highest and best use of the asset might provide maximum value to market participants through its use in combination with other assets and/or liabilities (e.g. a business).
- In such cases, 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 and/or liabilities and that those assets and liabilities (i.e. its complementary assets and the associated liabilities) would be available to and assumed by market participants respectively.

Liabilities associated include those that fund working capital, but do not include those used to fund assets other than those within the group of assets which are being fair valued.

### 9. How is fair value calculated for liabilities and entity's own equity instruments?

Fair Value Measurement assumes that the liability or entity's own equity instrument is transferred to a market participant at the measurement date. The fair value could be determined based on the identical or similar instruments held by other parties as assets or through use of valuation techniques.

#### For Liabilities:

The transfer is made on the premise that the liability would remain outstanding and the market participant transferee would be required to fulfil the obligation (i.e. the liability will continue for its scheduled term and would not be settled with the counterparty or otherwise extinguished on the measurement date).

#### For own Equity Instruments:

The transfer is made on the premise that the entity's own equity instrument would remain outstanding and the market participant transferee would take on the rights and responsibilities associated with the instrument (i.e., the equity instrument would not be cancelled or otherwise extinguished on the measurement date).

Para 47 of the Ind AS-113 states that the fair value of financial liability with a demand feature (i.e. payable on demand) is not less than the amount payable on demand, discounted from the first date the amount could be required to be paid.

Let us understand this with an example:

A NBFC accepts the deposit from its sister concern of ₹ 1000 for 5 years at interest rate of 5% p.a., whereas the prevailing market rate is 7% p.a. on identical deposit. Further, the deposit contains demand feature i.e. the holder can demand the repayment at any time.

With these terms, there is a fair value gain available with NBFC to the extent of interest rate difference of 2% (Market rate minus agreed rate). Considering the agreed terms, the fair value of the loan at the commencement date would be ₹ 918. A NBFC would not recognize this fair value gain of ₹ 82 (₹ 1000 – ₹ 918) on initial recognition, since the amount payable on demand would not be less than at least ₹ 1000 if the holder happens to ask for withdrawal on the very second day after placing the deposit. However, the said amount of ₹ 1000 need to be discounted to its present value for 5 years.

To summarize, the fair value of the loan is not lower than the transaction value at initial recognition i.e. ₹ 1000. Therefore, the amount payable on demand is ₹ 1000, which is then discounted from the first date as per para 47 of the standard.

Simply put, the fair value should not be less than the present value of the amount payable on demand.

**10. Does the fair value of liability include non-performance risk?**

Non-performance risk is the risk that an entity will not fulfill an obligation. It includes, but may not be limited to, the entity's own credit risk.

The fair value of a liability reflects the effect of non-performance risk.

As stated earlier, the fair value assumes that a transfer of liability will occur. Non-performance risk is assumed to be the same before and after the transfer of the liability. It is assumed that there is no change in the non-performance risk because of the transfer of liability to the new owner.

The entity shall take into account the effect of its credit risk and any other factors that might influence the likelihood that the obligation will or will not be fulfilled. That effect may differ depending on the liability, for example:

- whether the liability is an obligation to deliver cash (a financial liability) or an obligation to deliver goods or services (a non-financial liability).
- the terms of credit enhancements (for e.g. third-party guarantee) related to the liability, if any.

The liability may include a credit enhancement and the fair value is determined on basis of unit of account. If the entire liability (including credit enhancement) is treated as a single unit of account, then fair value is determined for them as a combined package but after excluding the effect of credit enhancement.

If the unit of account for the liability is not for the combined package, the entity would take into account its own credit standing and not that of third-party guarantor.

**11. How is restriction on transfer of liability or equity instrument treated?**

other inputs relating to the existence of a restriction that prevents the transfer of the item. The effect of a restriction that prevents the transfer is, either implicitly or explicitly, already included in the other inputs to the fair value measurement.

Fair value measurement requires the use of various inputs to the valuation. The entity shall not include a separate input or an adjustment to the fair value measurement.



## 12. List some of the parameters the entity can use while calculating fair values

The entity can apply the following to ascertain fair values:

- Quote on the stock exchanges if the securities are listed.
- Quote of a similar security and adjusting it to reflect specific circumstances of the security in question.
- Using various valuation techniques, such as discounted cash flows, etc.

## 13. Which valuation technique shall the entity use to calculate fair values?

Valuation technique to be used:

- should be appropriate in the circumstances.
- for which sufficient data are available.
- which maximizes the use of relevant observable inputs; and minimizes the use of unobservable inputs.

Observable inputs:

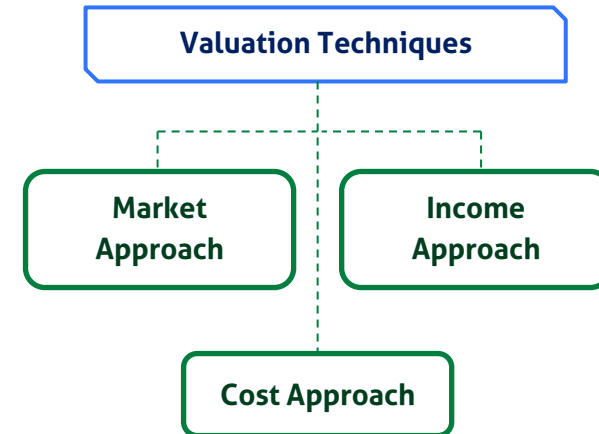
- developed using market data, such as publicly available information about actual events or transactions.
- Examples of markets in which inputs are observable are exchange markets, dealer markets, brokered markets and principal-to-principal markets.

Unobservable inputs:

- inputs for which market data are not available and, are developed using the best information available about the

assumptions that market participants would use when pricing the asset or liability.

## 14. Which are the various valuation techniques?



Market Approach:

- Fair values are calculated using prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities.
- E.g. valuation technique which uses P/E ratio and other market multiples of the comparable securities.

Cost Approach:

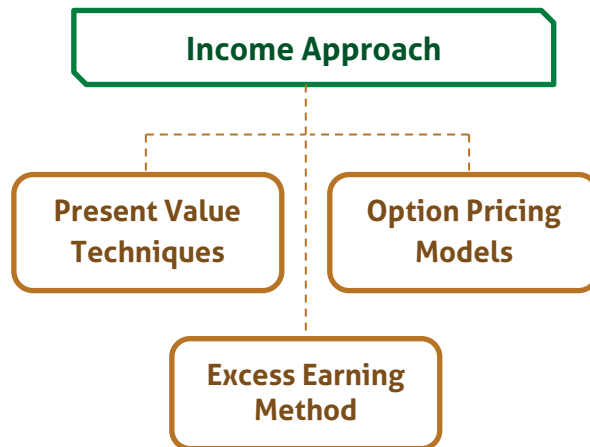
- Reflects the amount that would be required currently to replace the service capacity of an asset (current replacement cost).

- It is the price a market participant buyer will pay to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence.

### Income Approach:

- Uses future amounts, such as cashflows or income and expenses, to arrive at a single present amount.

Some of the valuation techniques under income approach are as follows:



### Present Value Techniques:

- Converts future amounts into a present amount using discount rate.
- Use inputs such as estimate of future cashflows, expectations about possible variations in amount, time value of money, risk premium, etc.

### Option Pricing Models:

E.g., Black-Scholes-Merton formula or a binomial model, that incorporate present value techniques and reflect both the time value and the intrinsic value of an option.

### Multi-Period Excess Earnings Approach:

- Calculates the fair value of intangible assets, by calculating the excess earning which the entity is getting (over normal returns) due to the goodwill, brand value, etc. of the entity.

### 15. How are the risks and expectations about variation in cashflows considered in present value techniques?

Fair value calculations are under conditions of uncertainty since the cash flows used are the estimated amounts rather than known amounts. Hence, fair value calculations must take into account the risk and uncertainty relating to the cashflows, as mentioned below:

There are broadly three methods of Present Value Calculation, differing in how they adjust for risk and in the type of cash flows they use:

### Discount-Rate Adjustment Technique:

- The rate is derived from observed rates of return for comparable assets or liabilities that are traded in the market (i.e. a market rate of return) and it is adjusted to include risk and uncertainty associated with cashflow.
- Uses that risk-adjusted discount rate along with contractual, promised or most likely cash flows.

- Contractual, promised or most likely cashflows are discounted.

### First Variant of Expected Present Value Technique:

- Uses risk-adjusted expected cash flows and a risk-free rate.

The starting point is expected cash flows. Expected cash flows represent probability-weighted average of all possible future cash flows. The various possible cash flows are listed alongside the expected probabilities of their occurrence. Then the two are multiplied and added to arrive at expected cash flows.

Possible Cash Flows	Probability %	Probability-Weighted Cash Flows (₹)
1000	25%	250
1100	45%	495
1150	30%	345
Expected cash flows		1090

The said amount of cash flows will now be adjusted to reflect the risk.

There are two types of risks – systematic and unsystematic risks. Unsystematic risks are risks which are specific to the particular asset or liability, whereas systematic risks are common risks shared by the asset or liability with other items in the diversified portfolio.

Unsystematic risks can be reduced and eliminated by diversifying the portfolio and hence they are called diversifiable risks. Portfolio theory holds that in a market in equilibrium, market participants will be compensated only for bearing the systematic risk inherent in the cash flows.

Assuming that risk-free rate is 6% and systematic risk premium is 4%:

### Risk-adjusted expected cash flows

$$= ₹ 1090 * (1 + 0.06) / (1 + 0.06 + 0.04)$$

$$= ₹ 1050.36$$

This signifies that market participant would treat certain (confirmed) cash flows of ₹ 1050.36 as equivalent to uncertain expected cash flows of ₹ 1090. Hence, under this variant, risk-adjusted expected cash flows of ₹ 1050.36 will be discounted with risk-free rate of 6%.

### Second Variant of Expected Present Value Technique:

- Uses non-risk adjusted expected cash flows and a discount rate adjusted to include the systematic risk premium that market participants require. (This rate is different from the rate used in the discount rate adjustment technique)

The expected cash flows will be calculated by the similar method as discussed above (multiplying the possible cash flows with respective probability percentage and adding them). This gives expected cash flows, without any adjustment for risk.

This will be discounted with a rate adjusted to include the risk premium that market participants require. In the above example, discount rate will be 6% + 4% = 10%.

Expected cash flows of ₹ 1090 will be discounted with rate of 10%.

## 16. What is Fair Value Hierarchy?

The Standard categorizes the inputs used in the fair value determination into three levels. This promotes consistency and comparability in fair value measurements and disclosures.

The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities and the lowest priority to unobservable inputs.

Three levels of inputs are – Level 1, 2 and 3.

Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date. This provides most reliable evidence of fair value.

Level 2 inputs are inputs (other than quoted prices included within Level 1) that are observable for the asset or liability, either directly or indirectly.

Examples:

- quoted prices for similar (as opposed to identical) assets or liabilities in active markets.
- quoted prices for identical or similar assets or liabilities in markets that are not active.
- Inputs other than quoted prices that are observable, e.g. interest rates and yield curves observable at commonly quoted intervals, implied volatiles, credit spreads, etc.

- *market-corroborated inputs* (Inputs derived principally from or corroborated by observable market data by correlation or other means.)

The adjustments can be made to Level 2 Inputs, based on factors specific to the asset or liability, such as the condition or location of the asset, comparability, volume of the markets in which inputs are observed, etc.

Level 3 inputs are unobservable inputs for the asset or liability.

## 17. At many places, Ind AS 113 contains reference of similar assets and identical assets. How are similar assets and identical assets different from each other?

These terms are not defined in Ind AS-113. It can safely be said that similar assets are those assets which, although are not the same assets as those being fair valued but possess significant similarity or resemblance in the characteristics. As opposed, identical assets mean the assets which have exactly the same characteristics or qualities to the assets which are being fair valued.

Identical assets qualify for Level 1 fair value, whereas similar assets qualify for Level 2 or Level 3 fair value, depending upon the quantum of adjustments made based on unobservable inputs.

## 18. How shall the entity develop unobservable inputs?

- The entity shall use unobservable inputs to measure fair value to the extent the relevant observable inputs are not available.
- It shall use the best information available in the circumstances, which might include the entity's own data.

- Unobservable inputs shall reflect the assumptions that market participants would use when pricing the asset or liability. The entity may begin with its own data, but it shall adjust those data if available information indicates that other market participants would use different data or there is something particular to the entity that is not available to other market participants (e.g. an entity-specific synergy).
- The entity shall take into account all information about market participant assumptions that is reasonably available.

#### 19. Can the entity use unobservable inputs in Level 2?

- Yes, it is allowed to make adjustments to level 2 inputs.
- It is subsequently evaluated whether such adjustments are material to entire fair value calculation. If the adjustments are significant to entire fair value calculation and the adjustment uses significant unobservable inputs, then the fair value will get classified as Level 3.

To conclude, the entity can use unobservable inputs in Level 2, however it should be insignificant to the entire fair value calculation to retain Level-2 hierarchy.

#### 20. Can the Fair Value Hierarchy be changed for a particular asset or liability?

The entity may fair value the asset or liability on a regular basis, at end of every reporting period. It is possible that the entity changes the valuation techniques or inputs to the fair valuation from one period to another if the change results in more representative fair

value or if more information becomes available about the asset or liability.

For example, an entity has an equity investment in a company. The investee company got listed during the current financial year. The investor entity earlier used to value the investment on basis of cash flows and other data, it can now do so on basis of quoted market price. In such cases, the fair value hierarchy would change from Level 3 to Level 1.

Hence, the entity can change the fair value hierarchy from one measurement date to another if the change in inputs results in more appropriate fair value.

**21. What are recurring and non-recurring fair values?**

Fair value may be needed either at a particular instance or at end of each reporting period for measurement and/or disclosure purposes.

For example, while accounting for business combination, fair valuation is needed only at time the control is obtained. While accounting for financial instruments, fair values may be required at each reporting period.

Recurring fair value measurements are those that other Standards require or permit in the balance sheet at the end of each reporting period, whereas non-recurring fair value measurements are those that other Standards require or permit in the balance sheet in particular circumstances, such as when a financial asset or liability is initially recognised at fair value and subsequently measured at amortised cost. One of the examples could be: Obtaining a 5-year loan from a group company at a rate lower than market rate. The said loan would be initially recognized at fair value and subsequently at amortised cost.

To simplify, if an asset is measured on fair value on recurring basis, it is recurring fair value measurement, otherwise it would be non-recurring fair value measurement.

Another example would be that Ind AS 105 requires an entity to measure an "Held for Sale" asset at the lower of its carrying amount and fair value less costs to sell. Since the asset's fair value less costs to sell is only recognised when it is lower than its carrying amount, that fair value measurement is non-recurring in nature. Whereas an asset measured at Fair Value through P & L at

each reporting date would be treated as measured at recurring fair value basis.

To summarize, while recurring fair value affects the measurement of given financial instrument at each reporting date, the non-recurring fair value does not affect the measurement.

**22. What should the entity do when volume or level of activity for an asset or a liability has significantly decreased in the market?**

The fair value of an asset or a liability might be affected when there has been a significant decrease in the volume or level of activity. The entity will need to undertake further analysis of the transactions or quoted prices.

If it is found that transaction or quoted price does not represent fair value, an adjustment to the price is made and that adjustment may be significant to the fair value measurement in its entirety.

The entity shall include appropriate risk adjustments, including a risk premium reflecting the amount to compensate for the uncertainty inherent in the cash flows of an asset or a liability.

The entity may also need to change the valuation technique or use multiple valuation techniques.

**23. Can the entity change the valuation technique?**

Ordinarily valuation techniques are applied consistently. However, a change in a valuation technique or its application can be done if the change results in a measurement that is equally or more representative of fair value in the circumstances.

The entity needs to disclose in the financial statements the valuation technique used and shall disclose the nature and reasons for change. Examples of situations where the entity may need to change valuation technique:

- There is a significant decline in the volume or level of activity in the market.
- There has been a major business acquisition made by the company during the year.
- There is substantial new capital investment made by the company.

#### 24. Whether the entity needs to consider subsequent events while measuring fair values?

The entity uses various information while calculating fair values, including various observable and unobservable inputs as on the measurement date.

The entity may become aware of new information subsequent to the measurement date or new developments may take place subsequent to measurement date.

Applying the principles of Ind AS 10, Events after the Reporting Period, the entity will need to determine whether the new conditions existed as on the measurement date or is it a completely new development and accordingly treat the same as adjusting or non-adjusting event.

For example, the entity is having an investment in a company (uses Level 3 inputs to value the same), the investee company is undergoing a litigation and subsequent to the measurement date,

the litigation is formally ruled against the investee company. It will be an adjusting event and the fair value will be revised on receipt of new information.

On the converse, any decline in value of listed securities subsequent to measurement date might not reflect the conditions on the measurement date and the fair value would not be revised.

#### 25. If the entity has a financial asset subsequently measured at amortised cost and the same has suffered drastic deterioration in the credit quality. This may lead to derecognition of original financial asset and recognition of new (deteriorated in credit quality) financial asset, if contractual cashflows have undergone substantial change. How should the entity account for the same?

There may arise certain circumstances where a financial asset which is subsequently measured at amortised cost suffers major impairment or loss in value. The entity will need to evaluate the extent to which the asset has changed.

If the modification is substantial, the entity will need to derecognize the original financial asset (to be followed by recognition of new financial asset).

For example, a financial asset currently having the amortized cost of ₹ 389 (EIR of 9%) in books was supposed to yield ₹ 100 p.a. to the entity for next five years. This has been renegotiated/structured due to deteriorating financial conditions of the counter party.

The counter party will now pay ₹ 40 p.a. for next 8 years. Discounting at 9% market rate, it gives the fair value of ₹ 221.39.

This can be said as substantial modification of the financial asset.

In accordance with the principles of para B5.5.25 of Ind AS 109, in such cases, the original financial asset existing in the books is derecognized and a new financial asset at lower value of ₹ 221.39 is recognised.

The new financial asset is “purchased or originated credit-impaired financial asset”. For purchased or originated credit-impaired financial assets, Effective Interest Rate (EIR) is to be calculated after considering the initial lifetime expected credit loss in the expected cash flows. Hence, it leads to reduction in fair value of such financial assets.

The question which arises is: what should be the impact given to the difference between the carrying amount of original financial asset and the reduced fair value of the new asset i.e.

$$₹ 389 - ₹ 221.39 = ₹ 167.61.$$

Whether the entity can take benefit of paragraph B5.1.2A(b) of Ind AS 109 (if the asset measurement otherwise qualifies under said para), which says that the difference between the fair value at initial recognition and the transaction price can be deferred instead of immediately charging it off in profit or loss.

To arrive at the answer, we look at the two of the major principles of the Standard:

- On derecognition of any financial asset, the difference between carrying amount and the consideration received is recognised in profit and loss. (consideration includes any new

asset obtained, and in this case, it shall mean the credit-impaired financial asset).

- When the entity does not have any reasonable expectation of recovering the amount of financial asset (either fully or in portion), it shall reduce the carrying amount to such extent.

Hence, going by the essence of these provisions, it can be concluded that the difference between the carrying amount of original financial asset and the reduced fair value of new financial asset, i.e. ₹ 167.61 shall be recognised in the profit and loss (as an expense) in the period in which the credit-impairment and the modification takes place. The same principles apply if modification leads to recognition of new financial asset at favourable terms than the previous financial asset which has been derecognized.

**26. Company DEF Ltd obtains a loan from the bank for ₹ 12 lakhs at 8% p.a., with ₹ 4 lakhs p.a. being repaid at end of each year along with the interest amount for the year. For this loan, the parent company, ABC Ltd has provided guarantee to the bank, without charging any fee from the subsidiary. If the parent would not have provided the guarantee, the bank would have charged 12% interest from the subsidiary. How would the parent account for the guarantee at the time of providing the same?**

The parent has provided a guarantee to the subsidiary's bank on behalf of the subsidiary. Ordinarily under the Accounting Standards (Indian GAAP), there would be no accounting entry in the books. However, Ind AS requires the company to compute the fair value of the guarantee given and recognize it in the books.



The fair value of the guarantee given shall be the financial liability and the same amount shall be recognised as investment in subsidiary on the asset side.

The fair value of guarantee will be the present value of amount the subsidiary saves because of the guarantee.

The entity shall calculate the present value of the difference between (1) actual contractual cash flows and (2) the contractual cash flows if the guarantee was not given by the parent.

Actual Loan Schedule:

Year	Opening Balance	Total Payment	Principal Portion	Interest Portion (8% p.a.)	Closing Balance (₹)
1	12,00,000	4,96,000	4,00,000	96,000	8,00,000
2	8,00,000	4,64,000	4,00,000	64,000	4,00,000
3	4,00,000	4,32,000	4,00,000	32,000	-
		<b>13,92,000</b>	<b>12,00,000</b>	<b>1,92,000</b>	

Notional Loan Schedule without Guarantee:

Year	Opening Balance	Total Payment	Principal Portion	Interest Portion (12% p.a.)	Closing Balance (₹)
1	12,00,000	5,44,000	4,00,000	1,44,000	8,00,000
2	8,00,000	4,96,000	4,00,000	96,000	4,00,000
3	4,00,000	4,48,000	4,00,000	48,000	-
		<b>14,88,000</b>	<b>12,00,000</b>	<b>2,88,000</b>	

Calculation of Fair Value of Guarantee:

Year	Actual Payments	Payments if Guarantee was not given	Benefit	Discounted Value
1	4,96,000	5,44,000	48,000	42,857
2	4,64,000	4,96,000	32,000	25,510
3	4,32,000	4,48,000	16,000	11,388
<b>Fair Value of Guarantee</b>				<b>79,756</b>

Hence, at the initial recognition, the parent shall recognise a financial liability for the fair value of guarantee of ₹ 79,756/- and the corresponding impact shall be given in investment in subsidiary account on the asset side.

In a situation where the entity is unable to determine the rate at which the loan would have been available without guarantee, the entity will need to estimate the rate at which the bank will make available loans to companies which are similar to subsidiaries in characteristics such as nature of business, operations, size, leverage ratios, etc.

The entity may take forward that rate in the calculations and compare it with actual rate of interest being charged to the subsidiary company.

The corporate guarantee fees, if charged to subsidiary could be one of the factors to measure the fair value of financial guarantee, however it may not be only determining factor for the fact that the transaction might have been influenced due to existence of related party relationship. On the converse, if there are instances, though rare, where

corporate guarantee fee is charged to third party in relation to guarantee extended in favour of third party, it may be used as benchmark to measure fair value of financial guarantee. Therefore, an entity needs to exercise significant degree of judgement on rational basis while using various valuation techniques in measuring fair value of financial guarantee.

## About **kcmGuide**

**kcmGuide** is a special publication prepared by area specific experts at K. C. Mehta & Co. This publication is intended to provide overall guidance on select topics / areas that may be of interest to readers. The idea is to provide to the reader an overall perspective on a particular topic in the form of a Guide which could serve as a referencer while practically dealing with the topic.

This publication is prepared exclusively for the benefit and use of the clients of K. C. Mehta & Co. This should not be used as a substitute for professional advice. Reasonable care has been taken for ensuring the accuracy and the authenticity of the contents of this publication. However, we do not take any responsibility for any error or omission contained therein on any account. It is recommended that the readers should take professional advice before acting on the same. No part of this document may be reproduced in whole or in part in any manner without prior written permission from K. C. Mehta & Co.

## Locations

### Ahmedabad

#### Arpit Jain

Level 11, Tower B,  
Ratnaakar Nine Square,  
Vastrapur,  
Ahmedabad - 380 015  
+ 91 79 4910 2200  
[arpit.jain@kcmehtha.com](mailto:arpit.jain@kcmehtha.com)

### Bengaluru

#### Payal Shah

19/4, Between 7th & 8th Cross,  
Malleswaram,  
Bengaluru - 560 003  
+91 80 2356 1880  
[payal.shah@kcmehtha.com](mailto:payal.shah@kcmehtha.com)

### Mumbai

#### Vishal Doshi

508, The Summit Business Bay,  
Nr. WEH Metro Station,  
Gundavali, Andheri East,  
Mumbai - 400 069  
+91 22 2612 5834  
[vishal.doshi@kcmehtha.com](mailto:vishal.doshi@kcmehtha.com)

### Vadodara

#### Milin Mehta

Meghdhanush,  
Race Course,  
Vadodara - 390 007  
+91 265 2440400  
[milin.mehta@kcmehtha.com](mailto:milin.mehta@kcmehtha.com)

Independent Member of

**B K R**  
INTERNATIONAL