PRACTICAL ISSUES IN APPLICATION OF **FAIR VALUE MEASUREMENT IN SRI LANKA**

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Executive Summary

Economically significant entities in Sri Lanka are legally required to prepare financial statements in accordance with Sri Lanka Accounting Standards. With the adoption of Accounting Standard SLFRS 13, Fair Value Measurement in Sri Lanka, fair value measurement of assets and liabilities and disclosures have been considered as a vital aspect in preparation of financial statements and in audit of such financial statements.

The Sri Lanka Accounting and Auditing Standards Monitoring Board in carrying out its functions, has observed several issues, relating to fair value measurement and disclosures.

When preparing financial statements, the management is required to understand the objective of fair value measurement and how fair value should be determined especially when market data are not available. Further, auditor's role is important when estimating fair value, as assumptions and other data used by the management are to be satisfied by the auditor as reasonable.
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Introduction

Fair value measurement has become more important in financial reporting in Sri Lanka with the adoption of Sri Lanka Accounting Standard SLFRS 13, Fair Value Measurement with effect from 1 January 2014. SLFRS 13 provides a single framework on how to measure fair value together with a single definition for fair value and with enhanced disclosure requirements. This standard applies to assets, liabilities and entity's own equity instruments which are required to be measured at fair value or when disclosures on fair value to be provided in the financial statements under other accounting standards.

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Fair value is about what an entity might realize by selling an asset or might pay to transfer a liability. Determining fair value is challenging and judgmental in certain instances which often requires variety of assumptions to be used. Therefore, practical application of some of the concepts in Sri Lankan context is rather challenging.

Function of Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB) is to monitor compliance with Sri Lanka Accounting Standards by economically significant entities in Sri Lanka and with Sri Lanka Auditing Standards by the auditors of such entities.

While discharging its statutory duties by SLAASMB, various issues in relation to fair value measurement in different areas have been identified. This document attempts to summarise such issues identified by SLAASMB with special focus on requirements in SLFRS 13 and relevant auditing standards.

Brief overview of SLFRS 13

Definition of fair value
SLFRS 13 defines the 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".

Asset or liability
According to the definition, a fair value measurement is for a particular asset or a liability. Therefore, when measuring fair value an entity shall take into account the characteristics of the asset or liability if market participants would take those characteristics into account when pricing the asset or liability at the measurement date. Such characteristics include, for example, the condition and location of the asset and restrictions if any, on the sale or use of the asset.

Transaction
A fair value measurement assumes that the asset or liability is exchanged in an orderly transaction to sell the asset or transfer the liability takes place either in the principal market for the asset or liability or in absence of a principal market, in the most advantageous market for the asset or liability.

Market participants
When measuring the fair value of an asset or a liability, an entity should use the assumptions that market participants would use when pricing the asset or liability, assuming that market participants act in their economic best interest.

Price
Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction in the principal (or most advantageous) market at the measurement date under current market conditions (ie an exit price) regardless of whether that price is directly observable or estimated using another valuation technique.

Fair value hierarchy
To increase consistency and comparability in fair value measurements and related disclosures, this SLFRS establishes a fair value hierarchy that categorises into three levels the inputs to valuation techniques used to measure fair value.
Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date.
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.
Level 3 inputs are unobservable inputs for the asset or liability.

Application issues observed by SLAASMB

- ***Fair value measurement of investments in debentures***

SLAASMB has observed that fair value of listed debt securities (listed corporate debentures) had been determined using prices of last recorded market transactions.

Based on the trading statistics published in the Colombo Stock Exchange website, transactions in debt market in Sri Lanka are less frequent and take place with lessor volume. This indicates that the Sri Lankan debt market is less active than the equity market and does not provide pricing information on an ongoing basis as per the requirements of SLFRS 13. Active market is defined in Appendix A to SLFRS 13 as a market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis. Therefore, an entity might need to make significant adjustments to that transaction price even when an observable transaction price is available for listed debt securities from an infrequent transaction which may not be at the measurement date, because the observable transaction price does not reflect the price in an active market at the measurement date.

- ***Valuation of consumable biological assets***

It has been observed by SLAASMB that valuation models used to value consumable biological assets such as timber, give large upfront profit, on or near the date of planting.

Most of the plantation companies in Sri Lanka use discounted cash flow model as the valuation technique to measure fair value of timber plantations. This technique uses number of inputs such as discount rate, pricing information, growth rates, volume details etc. Some of these inputs are observable while some are not. For example, risk premium included in the discount rate is unobservable. According to SLFRS 13, valuation techniques used to measure fair value shall maximise the use of relevant observable inputs and minimise the use of unobservable inputs.

Timber plantation cycle is normally a longer period and varies according to the species. For instance, Eucalyptus Grandis has 25 year cycle. During this cycle, value of timber trees at different ages are arrived at using the valuation technique. However, value is observable in the market only at the maturity (at the time of harvesting) and at the date of planting (i.e. the planting cost). As explained in SLFRS 13, if the transaction price is the fair value at initial recognition and a valuation technique that uses unobservable inputs will be used to measure fair value in subsequent periods, the valuation technique shall be calibrated so that at initial recognition, the results of the valuation technique equals the transaction price. Calibration ensures that the valuation technique reflects the current market conditions, and it helps an entity to determine whether an adjustment to the valuation technique is necessary (there might be a characteristic of the asset or liability that is not captured by the valuation technique).

If the valuation technique gives large upfront gain (i.e. when the values derived from the valuation technique on or near the date of planting is significantly higher than the initial cost of planting), that is not appropriate as no material biological transformation has taken place. This is further explained in Sri Lanka Accounting Standard LKAS 41, Agriculture, which states that cost may sometimes approximate fair value particularly when little biological transformation has taken place since initial cost incurrence, or when the impact of the biological transformation on price is not expected to be material.This highlights the requirement of calibrating the valuation model to avoid recognition of large upfront gain in the profit or loss.

- ***Valuation of properties***

SLAASMB has observed various issues relating to fair value measurement of properties.

o The most common issue observed by SLAASMB relating to valuation of real estate assets is not using prices of similar assets in arriving at the value of the asset considered under market approach. For example, valuing a land with a large extent (eg. few acres) by referring to the price of a small piece of land (eg. few perches) or referring price of residential property in valuing a commercial property or using prices of properties not in the same location and condition. SLFRS 13 requires the market approach to use prices and other relevant information generated by market transactions involving identical or comparable (i.e. similar) assets, liabilities or a group of assets and liabilities, such as a business. Accordingly, values determined not using prices of similar assets or liabilities may not represent the fair value. When an identical asset or a liability is not available, adjustment to the observable price may be required to capture effect of factors such as size, location, and condition.

o Using transactions between related parties as a basis for determination of fair value is another issue observed with regards to property valuation. If buyers and sellers in the principal (or most advantageous) market for the asset or liability are related parties as defined in LKAS 24, those parties are not independent to each other. If the price in a related party transaction is used as an input to a fair value measurement, the entity should have evidence that the transaction was entered into at market terms.

o In some cases, values are determined by relying on prices from websites which advertise sale of properties. These prices are offers made by sellers in looking for a buyer and not necessarily the fair value since the transaction takes place at a negotiated price and not at the offered price. Prices that are used to determine the fair value should be obtained from market data such as publicly available information about actual events or transactions, and that should reflect the assumptions that market participants would use when pricing the asset or liability.

o When properties are legally restricted for selling, not considering such restrictions in determining the value of the property has been another observation made by SLAASMB. These restrictions should have an impact on fair value unless the restriction is removed with the transfer of the property to the buyer.

> ***"When securities are trading with less frequency and volume, that market is not an active market in order to provide pricing information on an ongoing basis."***

- ***Fair value measurement of investments in equity securities***

o Fair value measurement of listed equity securities
Some listed shares (equity) are trading in the market with sufficient volume and frequency. However, there are some other listed shares which are not traded as such. Nevertheless, fair value of investment in these infrequently trading shares are measured using such trading prices. When securities are trading with less frequency and volume, that market is not an active market in order to provide pricing information on an ongoing basis. This is also a situation where some adjustment to the observed price may be necessary in arriving at the fair value, at the measurement date.

o Fair value measurement of equity securities which are not listed
In many instances, fair value of unlisted equity securities are determined using a valuation technique. SLAASMB has observed, in most of these cases, only one valuation technique is used to arrive at the fair value. A single valuation technique is appropriate only in some cases (eg. when valuing an asset or a liability using quoted prices in an active market for identical assets or liabilities).

In other cases (eg. when valuing a cash-generating unit), multiple valuation techniques are used. When multiple valuation techniques are used, the results shall be evaluated considering the reasonableness of the range of values indicated by those results. The fair value measurement is the point within that range that is most representative of fair value in the circumstances. However, such an evaluation has not been observed in many instances.

- ***Fair value measurement disclosures***

Failure to disclose description of the valuation techniques used and inputs used for fair value estimates had been one of the most common disclosure issue identified by SLAASMB. Unless these information is provided as required by SLFRS 13, the users of financial statements will be misled as they might assume the fair values stated are quoted market prices. Further, if the fair value hierarchy is not disclosed, the users will not be able to understand whether unobservable inputs are used in measurement.

Preparer's role in measuring fair value

Fair value is a market-based measurement, not an entity-specific measurement. The key factor that preparers should understand is that 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.
Accordingly, requirements such as introduction of adjustments to observable market transactions, concept of calibration, maximizing the use of observable inputs and minimizing the use of unobservable inputs are some of the areas that require special attention of preparers, as discussed above.

Further, based on the inputs used, the level of the fair value measurement should be determined and properly classified in the fair value hierarchy. In addition to that, proper disclosure of information required by SLFRS 13 should be made as it improves the reliability of the financial statements for the users.

Auditors Role in audit of estimates

When auditing fair value measurements, the auditors need to consider the standards and guidance provided in Sri Lanka Auditing Standards especially Sri Lanka Auditing Standard SLAuS 540, Auditing Accounting Estimates, including Fair Value Accounting Estimates and related Disclosures and SLAuS 620, Using the Work of an Auditor's Expert in the audit of the relevant financial statements. An appropriate understanding of the requirements of the rel evant standards read together with other available materi als relating to the subject would facilitate the audit of the relevant financial statements by the auditors.

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Moreover, when performing risk assessment procedures, auditor needs to obtain an understanding of the following key areas in addition to the other aspects stated in the standards, in order to provide a basis for the identification and assessment of the risks of material misstatements;

- o How management identifies the need for accounting estimates
- o How management makes the accounting estimates, including methods used, controls, whether an expert is involved and assumptions used.

Auditor may require to identify the fair value measurement as having significant risk, if, in auditor's judgement, the degree of uncertainty is high.

When obtaining audit evidence about an entity's fair value measurements and disclosures, the auditor needs to evaluate whether:

a. The assumptions used by management are reasonable;
b. The fair value measurement was determined using an appropriate model, if applicable; and
c. Management used relevant information that was reasonably available at the time.

A particular assumption that may appear reasonable when taken in isolation may not be reasonable when used in conjunction with other assumptions. Calibration of the model maybe necessary to provide a reasonable assurance that the assumptions are internally consistent.

The auditor should evaluate the appropriateness of the expert's work as audit evidence regarding the assertions being considered when management has used an expert in ascertaining the fair value.

When considering whether the expert has used source data which is appropriate in the circumstances, the auditor would consider the following procedures:

d. Making inquiries regarding any procedures undertaken by the expert to establish whether the source data is relevant and reliable.
e. Reviewing and testing the data used by the expert.

If the results of the expert's work do not provide sufficient appropriate audit evidence or if the results are not consistent with other audit evidence, the auditor should resolve the matter. This may involve discussions with the entity and the expert, applying additional audit procedures, including possibly engaging another expert, or modifying the auditor's report.

Observations made by SLAASMB in relation to audit of fair value estimates

A common observation made by SLAASMB was, relying on fair value estimate done by the management (or management's expert) without undertaking further audit tests.
In some cases, not testing the reasonableness of the assumptions used by the management has been observed. For example, how they conform to the entity's business plan and the external environment, or to matters that are outside the control of the entity, such as interest rates, variability and the timing of future cash flows.
When discounted cash flow technique has been used by the management to ascertain the fair value, sometimes, auditor has not tested data used by the management such are prices and cost information, with other corroborative evidence that are reasonably available.

Conclusion

Based on the observations of SLAASMB on accounting for fair values and auditing on such fair values, it can be concluded that the preparers and auditors need to pay more attention to the requirements of relevant accounting and/or auditing standards when fair values are involved in order to enhance reliability of financial reporting.

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