CHAPTER 2

Key accounting and financial reporting issues- Fair valuation and financial instruments

This article aims to:

- Provide an overview of the key observations highlighted by the regulators relating to disclosure and accounting of fair value measurement and financial instruments.

Introduction

Financial reporting enables companies to recount the transactions and events that have taken place in a company during a reporting period. It provides insight and transparency regarding the operations of the company, and thus facilitates users to make financial decisions, such as investing, lending, etc.

High-quality financial reporting, which complies with relevant accounting and reporting standards, has been at the forefront of regulators' priorities. Accordingly, regulators are globally undertaking reviews of financial statements of companies and highlighting non-compliances or improvement points.

In our series of key accounting and financial reporting issues, we will touch upon some of the key areas that regulators have highlighted and provided improvement points in the area of **fair value measurement and financial instruments**, and will also provide illustrations of disclosures from thematic reviews performed by the Financial Reporting Council (FRC) and illustrative disclosures issued by KPMG IFRG Limited in 2023.

While preparing this article, we have referred to:

- The recent observations of the National Financial Reporting Authority (NFRA),
- The Ind AS observations of the Financial Reporting Review Board (FRRB) of the Institute of Chartered Accountants of India (ICAI),
- The report- Annual Review of Corporate Reporting (2022/23) issued by the Financial Reporting Council, and
- Recent ESMA[1] enforcement directions.

1. European Securities and Markets Authority

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Key issues and recommendations pertaining to fair value measurement and financial instruments

Expected Credit Loss (ECL) and credit risk

- ***Use of forward-looking information:*** As per IFRS 9, *Financial Instruments,* while computing ECL, an entity should *inter alia* consider reasonable and supportable information about past events, current conditions and forecasts of future economic conditions (or Forward-Looking Information (FLI)). In this regard, the following was observed:

  ECL on Trade receivables: In making ECL assessments for trade receivables and contract assets using a provision matrix, historical default rates should be reviewed and adjusted for FLI.

  Disclosures of FLI: While explaining the inputs, assumptions and estimation techniques used to compute ECL (as required by IFRS 7, *Financial Instruments: Disclosures*), disclosures should be made on how FLI and other macroeconomic conditions have been incorporated in computing ECL. (Refer illustrative disclosures)

Illustrative disclosure: Adjustment of historical loss rates with FLI

Exposures within each credit risk grade are segmented by geographic region and industry classification and an ECL rate is calculated for each segment based on delinquency status and actual credit loss experience over the past seven years. These rates are multiplied by scalar factors to reflect differences between economic conditions during the period over which the historical data has been collected, current conditions and the Group's view of economic conditions over the expected lives of the receivables.

Scalar factors are based on GDP forecast and industry outlook and include the following: 1.3 (2022: 1.2) for [Country X], 0.9 (2022: 0.2) for [Country Y] and 1.1 (2022: 1.2) for [Industry A].

(Source: KPMG in India's analysis, read with Guide to annual financial statements – Illustrative disclosures issued by KPMG IFRG Limited in 2023)

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- ***Reconciliation of ECL:*** As per IFRS 7, companies are required to provide a reconciliation from the opening balance to the closing balance of the loss allowance to explain the changes in the loss allowance. Such a reconciliation should also include how significant changes to the gross carrying amount of the financial instruments[2] during the period contributed to the changes in loss allowance. (Refer illustrative disclosure)

Illustrative disclosure: reconciliation of ECL

Movements in the allowance for impairment in respect of trade receivables and contract assets

The movement in the allowance for impairment in respect of trade receivables and contract assets during the year was as follows:

In thousands of INR	**2023**	**2022**
Balance at 1 January	**214**	26
Amounts written off	**(80)**	(5)
Amounts derecognised due to discontinued operation	**(25)**	-
Net remeasurement of loss allowance	**211**	193
Balance at 31 December	**320**	214

The following significant changes in the gross carrying amounts of trade receivables contributed to the changes in the impairment loss allowance during 2023:

- The growth of the business in [*Countries A, B, X and Y*] resulted in increases in trade receivables of INR 4,984 thousand (2022: INR 2,356 thousand) and INR 4,556 thousand (2022: INR 2,587 thousand) respectively and increases in impairment allowances of INR 30 thousand (2022: INR 14 thousand) and INR 44 thousand (2022: INR 23 thousand) respectively;
- Increases in credit-impaired balances in [*Countries D and Z*] of INR 143 thousand (2022: INR 98 thousand) resulted in increases in impairment allowances of INR 47 thousand (2022: INR 44 thousand); and
- A decrease in trade receivables of INR 3,970 thousand attributed to the Packaging segment, which was sold in February 2023, resulted in a decrease in the loss allowance in 2023 of INR 25 thousand.

(Source: KPMG in India's analysis, read with Guide to annual financial statements – Illustrative disclosures issued by KPMG IFRG Limited in 2023)

2. For example:
   a. Changes because of financial instruments originated or acquired during the reporting period
   b. The modification of contractual cash flows on financial assets that do not result in a derecognition of those financial assets
   c. Changes because of financial instruments that were derecognised during the reporting period, etc.

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- ***Disclosures of credit risk:*** To enable users of financial statements to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows, companies should *inter alia* disclose the approach and significant assumptions applied in the measurement of ECL, such as what is considered as significant increase in credit risk, default, etc., quantitative criteria applied to stage transfers (i.e. from stage 1 to 2) and probation period for transfer back (i.e. from stage 2 to 1) should be disclosed. Concentrations of risks, details of probability of default and loss given default, where these are used in computation of ECL and are considered material, should be provided. (Refer illustrative disclosures)

Illustrative disclosure: Credit risk pertaining to debt securities

The Group monitors changes in credit risk by tracking published external credit ratings. To determine whether published ratings remain up to date and to assess whether there has been a significant increase in credit risk at the reporting date that has not been reflected in published ratings, the Group supplements this by reviewing changes in bond yields and, where available, Credit Default Swap (CDS) prices together with available press and regulatory information about debtors.

12-month and lifetime probabilities of default are based on historical data supplied by [*Rating Agency X*] for each credit rating and are recalibrated based on current bond yields and CDS prices. Loss given default parameters generally reflect an assumed recovery rate of 40 per cent, except when a security is credit-impaired, in which case the estimate of loss is based on the instrument’s current market price and original effective interest rate.

(Source: KPMG in India’s analysis, read with Guide to annual financial statements – Illustrative disclosures issued by KPMG IFRG Limited in 2023)

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Disclosure pertaining to financial instruments

- ***Risks arising from financial instruments:*** IFRS 7 requires qualitative[3] and quantitative disclosures of the nature and extent of risks arising from financial instruments to which an entity is exposed at the reporting date, and how the entity has managed them. Corporates should consider whether inflation and rising interest rates would be material risks, and *inter alia* disclose:
  - The methods used to measure exposure to risks and whether there are any changes in these methods as compared to the previous period (as required by IFRS 7). Also, the sensitivity analysis of the risks should be disclosed
  - Any hedging arrangements have been put in place to fix interest rates or hedge against the effects of inflation[4]
  - Information about collateral held as security and other credit enhancements should be disclosed as part of credit risk. (Refer illustrative disclosure)

Illustrative disclosure: Company does not hold collateral for trade and other receivables

The Group does not require collateral in respect of trade and other receivables. The Group does not have trade receivable and contract assets for which no loss allowance is recognised because of collateral.

(Source: KPMG in India's analysis, read with Guide to annual financial statements – Illustrative disclosures issued by KPMG IFRG Limited in 2023)

3. For each type of risk arising from financial instruments, a company should disclose the following:
   - The exposure to the risk and how it arises
   - The methods used to measure the risk, and
   - The entity's objectives, policies and processes for managing the risk.
4. Where inflationary features are embedded in contracts, they may be separated and accounted for as derivatives. Companies need to disclose relevant information for users to understand such contractual features.

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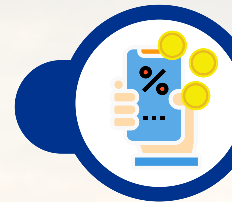
- ***Derecognition of equity instruments measured at FVOCI:*** When an entity derecognises investments in equity instruments measured at Fair Value through Other Comprehensive Income (FVOCI) during a reporting period, it should disclose the following in accordance with IFRS 7:
  - The reasons for disposing the investments
  - The fair value of the investment at the date of derecognition, and
  - The cumulative gain or loss on disposal.
- ***Reclassification of financial assets:*** An entity may reclassify a financial asset (say from amortised cost to FVOCI) only when there is a change in the business model for managing financial assets. As per IFRS 9, *Financial Instruments*, changes in the business model are expected to be very infrequent. Such a change is determined by the entity's senior management, must be significant to the entity's operations, demonstrable to external parties and is only possible if the entity begins or ceases to perform an activity that is significant to its operations. Changes in management of financial assets (for example, a revised investment strategy developed by a new management) does not meet this criterion and therefore, the condition for reclassification of financial assets is not fulfilled.

  However, in specific circumstances, where the condition for reclassification is fulfilled, entities should provide prescribed disclosures in accordance with IFRS 7 i.e.
  - Date of reclassification
  - A detailed explanation of the change in the business model and a qualitative description of its effect on the entity's financial statements
  - The amount reclassified into and out of each category.



Offsetting of financial instruments

- As per IAS 32, *Financial Instruments: Presentation*, financial instruments should be offset and a net amount presented in the balance sheet when an entity has a legal right to offset the financial asset and financial liability and the intention is either to settle on a net basis, or to realise the asset and settle the liability simultaneously. Accordingly, for the purpose of presentation in the cash flow statement, cash and overdraft balances should be offset only when the qualifying criteria is met.

Disclosures of fair value measurement

IFRS 13, *Fair Value Measurement*, requires companies to disclose the fair value hierarchy, that categorises into three levels the inputs to valuation techniques used to measure fair value.

- Some of the observations pertaining to recurring[5] level 3 measurements include the following:
  - While significant unobservable inputs and adjustments were disclosed, quantitative information regarding these inputs and adjustments is required,
  - Along with a narrative description, a quantitative sensitivity analysis for financial instruments categorised within level 3 of the fair value hierarchy would give a sense of the potential variability of the measurement (refer the illustrative disclosure), and
  - A reconciliation of movements in fair value.

5. Those measurements that other IFRSs require or permit in the balance sheet **at the end of each reporting period**- e.g. financial liability in respect of contingent consideration on acquisition of a business

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Illustrative disclosure: Quantitative sensitivity disclosure for financial instruments within level 3

The fair value of the Group's investments is INRX (20XX: INRY). The following analysis is provided to illustrate the sensitivity of the fair value of investments to a change in an individual input, while all other variables remain constant. The Board considers these changes in inputs to be within reasonable expected ranges. This is not intended to imply the likelihood of change or that possible changes in value would be restricted to this range

Input	Base case[1*]	Change in input[1*]	Change in fair value of investments (in INR)
Discount rate	6-7%	+ 0.5% - 0.5%	(69,667) 74,206
Energy yield	P50	10 – year P90 10 – year P10	(128,748) 127,684
Power price	Forecast by leading consultant[2*]	-10% +10%	(135,947) 130,850
Inflation rate	2% long term	-0.5% +0.5%	(60,757) 64,581
Asset life	30 years onshore/ 35 years offshore	- 5 years + 5 years	(148,179) 102,394

The sensitivities above are assumed to be independent of each other[3*].

Combined sensitivities are not presented.

Notes for consideration:

1*: The company should separately explain how the base case and reasonably possible changes in inputs were determined

2*: The Company should explain how frequently the forecasts provided by consultants are updated and may be adjusted where the investment manager considers that more conservative assumptions are appropriate.

3*: Sensitivities are provided separately for each significant level 3 input.

(Source: KPMG in India's analysis, read with CRR Thematic Review: IFRS 13 *'Fair Value Measurement'* issued by FRC in June 2023)

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Climate-related matters

Investors have started factoring climate related matters – i.e. both physical risks (such as, rising sea levels) and transition risks (such as, changes in relevant legislations) into their valuations. These will impact fair value measurements in different ways.
Where such information is material, companies should explain how the impact of climate-related matters has been incorporated in fair value measurements and quantify the significant estimation uncertainty. Where such risks have not been considered, however, it would impact the valuation in the future, such disclosure should also be made. (Refer illustrative disclosure)

Illustrative disclosure: Extract of valuation methodology for investment properties

Other factors that are taken into account include structural and environmental conditions. With regard to the latter factor, the valuers made no explicit adjustment to their valuations as at 31 December 20XX in respect of ESG matters. However, both the Group and the valuers anticipate that ESG will have a greater influence on valuations in the future as investment markets place a greater emphasis on this topic.

(Source: KPMG in India's analysis, read with CRR Thematic Review: IFRS 13 *'Fair Value Measurement'* issued by FRC in June 2023)

Borrowing related disclosures

Information about banking covenants should be provided unless the likelihood of any breach is considered remote. Additionally, the effect of refinancing and changes to covenant arrangements should be explained (refer illustrative disclosure). Borrowers should recognise interest expense on the borrowing irrespective of whether or not the lender correspondingly recognizes interest income on that loan. For example, certain lenders, such as banks, do not recognise interest on Non-Performing Assets (NPAs) in accordance with the regulations applicable to them. However, the borrowers considered as NPA, should continue to recognise the interest expense.

Illustrative disclosure: Loan covenant waiver

As explained in [Note X], the Group exceeded its maximum leverage threshold (loan covenant ratio, calculated as debt to quarterly revenue for continuing operations) associated with a bank loan in the third quarter of 2023. The Group obtained a waiver of the breach of covenant in October 2023 for a period of 18 months. Subsequent to 31 December 2023, the bank revised the loan covenant ratio from 2.5 to 3.5 times and the waiver was lifted. On the basis of the new covenant and its forecasts, management believes that the risk of the new covenant being breached is low.

(Source: KPMG in India's analysis, read with Guide to annual financial statements – illustrative disclosures issued by KPMG IFRG Limited in 2023)

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Significant estimation uncertainty

As per IAS 1, *Presentation of Financial Statements*, an entity should disclose information about assumptions it makes about the future or other major sources of estimation uncertainty that would significantly adjust the carrying amounts of assets or liabilities. With regard to fair value measurement, companies should disclose any significant estimation uncertainty in relation to fair value measurements (refer illustrative disclosure). Companies should also consider obtaining specialist third party advice, when the fair valuation is likely to be material and where no internal expertise exists. For example, third party specialists in valuation of land or property, etc.

Illustrative disclosure: Significant estimation uncertainty on fair value measurements (timber industry)

The Group assessed the impact of climate-related risks and opportunities on the estimated yields per hectare for younger standing timber while computing the fair value. By considering the impact of higher temperatures (an increase of 2ºC by 2050) on the growth rate of pine trees and on the intensity and frequency of storms, the Group concluded that, overall, the positive effects (accelerated growth) and negative effects (increase in the frequency of storms) would have an immaterial impact on yields. Due to the high degree of estimation uncertainty around the impact of climate change on the intensity and frequency of storms, this conclusion may change in the future.

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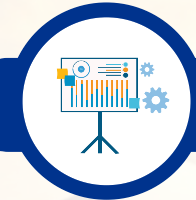

Other observations

- **Accounting policies:** Accounting policies should be provided for all material transactions to enable users to understand how these transactions have been accounted. This includes initial recognition and subsequent measurement, financing (including factoring and reverse factoring) and hedging arrangements, and any changes in the arrangements.
- **Consistent information:** Companies should ensure that information in the annual report is consistent across the report. For example, where the management commentary includes inflationary risks, climate related risks, etc. as significant risks faced by the entity, the disclosures pertaining to financial instruments and fair value measurement should reflect these as significant risks impacting the business and how the management is dealing with the same.
- **Market participant assumption:** Companies should ensure that in accordance with IFRS 13, represent market participant[6], rather than company-specific assumptions. These assumptions should be based on the **current** market conditions at the **measurement date**. For example, the fair value of related party transactions should be computed using market participant's assumptions about the associated risk[7].
- **Company specific disclosures:** Companies should provide additional information where it is necessary to meet the overall disclosure objective of the standard, not just the specific requirements, and avoid boilerplate and immaterial information.
- **Aggregation of information:** Fair value hierarchy disclosures are required to be made for each class of assets and liabilities, where the class is determined on the basis of the nature, characteristics and risks. Further disaggregation might be required for fair value measurements categorised within Level 3 of the fair value hierarchy because those measurements have a greater degree of uncertainty and subjectivity. Companies should ensure that the level of aggregation of information on fair value measurements results in useful disclosures.

6. 'Market participants' are buyers and sellers in the principal or most advantageous market. Market participants are assumed to be knowledgeable about the asset or liability, using all available information, including information that would be expected to become available in customary and usual due diligence. To the extent that additional uncertainty exists, it is factored into the fair value measurement.
7. In certain cases, there could be an off-market element (i.e. the difference between the fair value and the transaction value). This off-market element may represent a capital contribution or a deemed distribution.

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- **Derecognition of financial liabilities:** As per IFRS 9, a financial liability is derecognised when it is extinguished, i.e. it is discharged or cancelled or expires. This *inter alia* includes when the borrower is legally released from the primary responsibility for the financial liability. However, interest on the liability would continue to be recognised till the financial liability is derecognised from the financial statements, for example, even when there are negotiations with the lender to waive off the liability, etc.
- **Interest on financial assets:** Interest income on financial assets measured at amortised cost should be recognised using the effective interest method. Where it is expected that amounts would not be received, an impairment would be created on the financial asset using the ECL method.
- **Schedule III disclosures:** As per Division II to Schedule III of the Companies Act, 2013:
  - ***Loans to related parties*** should be bifurcated into the current and non-current component. Additionally, it should also be disclosed whether such loans are secured or unsecured and what amount is considered good or considered doubtful.
  - ***Investments*** should be bifurcated as quoted or unquoted and market value of quoted investments should be disclosed.

Conclusion

The article highlights observations of the regulators pertaining to certain key areas of the standards. Therefore, companies should take note of these requirements of the accounting standards and provide adequate disclosures.

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