

Query No. 11

Subject: Adoption of 'Net Book Value' method as one of the valuation technique to measure the fair value of investments in equity instruments that do not have a quoted market price in an active market.¹

A. Facts of the Case

1. A company (hereinafter referred to as 'the Company') is a wholly owned Government of India company under the Department of Atomic Energy. It was established in the year 1967, primarily to meet the control and instrumentation requirements of India's nuclear power programme. The Company has played a pioneering role in spurring the growth of indigenous electronic industry in the country. The Company is a multi-product, multi-disciplinary and multi-technology organisation providing cutting edge technology solutions to the strategic users in Defence, Atomic Energy, Aerospace, Electronic Security and Information Technology (IT) & e-Governance.

2. A Corporation Ltd. has the first gas based power plant that was set up in the State. In the year 1990, when there was an acute shortage of power in the State, the then Electricity Board invited the private companies to start gas power projects under public and private partnership (PPP) mode. Accordingly, State Transmission Corporation, state distribution companies, some public sector companies, including 'the Company' and other private sector companies, had come forward for setting up of gas based power plant in the State i.e., A Corporation Ltd.

3. Through such PPP mode, the Company as a promoter shareholder had invested in A Corporation Ltd. to the tune of Rs. 91.12 lakhs. A Corporation Ltd. is not a listed company in any of the Stock Exchanges. In addition to the investment in A Corporation Ltd., the Company holds shares in two other entities, viz., its joint venture, X Ltd. and Y Consumer Co-operative Society Limited. All these three investments are being disclosed in the 'Investment' schedule in the Company's balance sheet.

4. *Pre Ind AS Regime:* The querist has stated that prior to adoption of Indian Accounting Standards (Ind ASs), i.e., till the end of 31.03.2015, the Company in line with Accounting Standard (AS) 13, 'Accounting for Investments', had framed the accounting policy on investments as under:

“Long term Investments are carried at cost. Provision is made for diminution, other than temporary, in the value of such investments.”

Accordingly, the Company had been disclosing the value of investments made in X Ltd., A Corporation Ltd. and Y Consumer Co-operative Society Limited at cost, i.e., at Rs. 73.50 lakhs, Rs. 91.12 lakhs and Rs. 0.02 lakhs respectively.

5. *Post adoption of Ind AS:* The Company having net worth of more than Rs. 500 crore is required to adopt Ind AS and accordingly, the Company had adopted Ind AS from the financial year (F.Y.) 2016-17 in accordance with the Notification dated February 16, 2015 issued by the Ministry of Corporate Affairs, Government of India. Post implementation of Ind AS, during the F.Y. 2016-17 and 2017-18, the Company had adopted the following

¹ Opinion finalised by the Committee on 20.6.2022.

accounting policy in respect of accounting for investments as the Company had not consolidated the accounts with that of the joint venture company.

“Investments including Investments in joint venture are valued at Fair Value under Net Book Value method.”

However, based on the opinion issued by the Expert Advisory Committee of the ICAI, from the F.Y. 2018-19 onwards, the Company is preparing the consolidated accounts with that of Joint venture company and accordingly revised the accounting policy on investments as under:

“Investments other than investments in joint venture are valued at Fair Value through Other Comprehensive Income (FVOCI) under Net Book Value Method. Investments in Joint Venture are valued at Cost.”

Since then, for each financial year, the Company had been valuing the investment in A Corporation Ltd. at fair value through OCI. For re-measuring the value of investments in A Corporation Ltd., the Company had been adopting the net book value method based on latest audited financial statements of A Corporation Ltd. and accordingly routing the re-measurement made through ‘Other Comprehensive Income’.

Current Scenario:

6. The querist has further stated that the Company, being a public sector enterprise, is subject to supplementary audit by the Comptroller and Auditor General of India (C&AG). During the course of supplementary audit for the F.Y. 2020-21, the C&AG audit team has issued an audit query stating that “*Valuation of investment in equity shares of A Corporation Ltd. as per net book value method instead of cost had resulted in overstatement of Investments*”. The contention of the C&AG audit team was based on the following factors:

- a) The net book value method or equity method is a prescribed method of valuation of investments in associates or joint ventures according to Ind AS 28, ‘Investments in Associates and Joint Ventures’ or Ind AS 31, ‘Interests in Joint Ventures’.
- b) The investments in equity instruments of an unlisted company which is neither an associate nor joint venture need to be measured according to Ind AS 39, ‘Financial Instruments : Measurement and Recognition’.
- c) As per paragraph 9 of Ind AS 39, investments in equity instruments that do not have a quoted market price in an active market, and whose fair value cannot be reliably measured shall not be designated as at fair value through profit or loss.
- d) Also, as per paragraph 46(c) of Ind AS 39, after initial recognition, an entity shall measure financial assets at their fair values except for investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured, which shall be measured at cost.

Hence, based on the above factors and since the equity shares of A Corporation Ltd. are not traded in active market, the C&AG audit team contended that the investment in A Corporation Ltd. need to be measured at cost and not doing so (adopting net book value method) had resulted in overstatement of investments and thereby the other comprehensive income.

(Emphasis supplied by the querist.)

7. *Company's view points:*

- a) As per paragraph 46 of Ind AS 39, after initial recognition, an entity shall measure financial assets at their fair values.
- b) Paragraph AG74 of Ind AS 39 deals with valuation technique in case of no active market related instruments. If the market for financial instruments is not active, an entity establishes fair value by using a valuation technique. Valuation techniques include, using recent arms market transactions between knowledgeable, willing parties, if available.
- c) Since the Company is a joint promoter shareholder, i.e., 25 companies jointly floated A Corporation Ltd. to generate the power and to utilise the same for their captive consumption, the value of the instrument cannot be inferred from an outside market since it is a closely held company.
- d) Paragraph AG74 of Ind AS 39 suggests the valuation techniques, "to include ...", i.e., it is an inclusive definition but not a restrictive or exhaustive definition.
- e) Since the 'Net Book Value' method is one of the accepted methods for valuation, the Company has chosen this method based on the latest available audited financials of A Corporation Ltd. which gets recorded at various Government agencies like Registrar of Companies (ROC), Income-tax Authorities etc.,
- f) In view of the above, it is felt that the valuation method adopted for investments in A Corporation Ltd. based on net book value method is in order.

B. Query

8. In view of above, the opinion of Expert Advisory Committee is sought as to whether the adoption of 'Net Book Value' method by the Company as one of the valuation technique to measure the fair value of investments in equity instruments of A Corporation Ltd. that do not have a quoted market price in an active market is in order or shall be measured at cost.

C. Points considered by the Committee

9. The Committee notes that the basic issue raised in the query relates to valuation of investment in equity instruments of A Corporation Ltd. (a closely held company) that do not have a quoted market price in an active market and which is not investment in subsidiary, joint venture and associates. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, accounting for other investments made by the Company, viz., in X Ltd. and Y Co-operative Society Ltd., whether joint venture companies are required to be consolidated with the accounts of the Company, accounting for investments under previous GAAP, accounting for transactions between A Corporation Ltd. and the Company or promoter companies, application of the requirements of Ind AS 8, 'Accounting Policies, Changes in Accounting Estimates and Errors', accounting adjustments at the time of transition to Ind AS etc. Further, the Accounting Standards referred hereinafter are Indian Accounting Standards, notified under the Companies (Indian Accounting Standards) Rules, 2015, as amended/revised from time to time.

10. At the outset, the Committee wishes to point out that Ind AS 31, 'Interests in Joint Ventures' and Ind AS 39, 'Financial Instruments: Recognition and Measurement' were not notified under Companies (Indian Accounting Standards) Rules, 2015 and hence, the same are not applicable in the extant case. With regard to valuation of investment in equity instruments of A Corporation Ltd., the Committee notes that A Corporation Ltd. is not a subsidiary, joint venture or associate of the Company. Further, the investments in equity instruments being

financial assets as per the requirements of Ind AS 32, 'Financial Instruments: Presentation', the requirements of Ind AS 109, 'Financial Instruments' are applicable for financial reporting of such investments (financial instruments). Accordingly, in the context of the issue raised, the Committee notes the following requirements of Ind AS 109:

“4.1 Classification of financial assets

4.1.1 Unless paragraph 4.1.5 applies, an entity shall classify financial assets as subsequently measured at amortised cost, fair value through other comprehensive income or fair value through profit or loss on the basis of both:

- (a) the entity’s business model for managing the financial assets and**
- (b) the contractual cash flow characteristics of the financial asset.**

4.1.2 A financial asset shall be measured at amortised cost if both of the following conditions are met:

- (a) the financial asset is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows and**
- (b) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.**

Paragraphs B4.1.1–B4.1.26 provide guidance on how to apply these conditions.

4.1.2A A financial asset shall be measured at fair value through other comprehensive income if both of the following conditions are met:

- (a) the financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets and**
- (b) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.**

Paragraphs B4.1.1–B4.1.26 provide guidance on how to apply these conditions.”

“4.1.4 A financial asset shall be measured at fair value through profit or loss unless it is measured at amortised cost in accordance with paragraph 4.1.2 or at fair value through other comprehensive income in accordance with paragraph 4.1.2A. However an entity may make an irrevocable election at initial recognition for particular investments in *equity instruments* that would otherwise be measured at fair value through profit or loss to present subsequent changes in fair value in other comprehensive income (see paragraphs 5.7.5–5.7.6).”

“Investments in equity instruments

5.7.5 At initial recognition, an entity may make an irrevocable election to present in other comprehensive income subsequent changes in the fair value of an investment in an equity instrument within the scope of this Standard that is neither *held for trading* nor contingent consideration recognised by an acquirer in a business combination to which Ind AS 103 applies. ...”

“Investments in equity instruments and contracts on those investments

B5.2.3 All investments in equity instruments and contracts on those instruments must be measured at fair value. However, in limited circumstances, cost may be an appropriate estimate of fair value. That may be the case if insufficient more recent information is available to measure fair value, or if there is a wide range of possible fair value measurements and cost represents the best estimate of fair value within that range.

B5.2.4 Indicators that cost might not be representative of fair value include:

- (a) a significant change in the performance of the investee compared with budgets, plans or milestones.
- (b) changes in expectation that the investee’s technical product milestones will be achieved.
- (c) a significant change in the market for the investee’s equity or its products or potential products.
- (d) a significant change in the global economy or the economic environment in which the investee operates.
- (e) a significant change in the performance of comparable entities, or in the valuations implied by the overall market.
- (f) internal matters of the investee such as fraud, commercial disputes, litigation, changes in management or strategy.
- (g) evidence from external transactions in the investee’s equity, either by the investee (such as a fresh issue of equity), or by transfers of equity instruments between third parties.

B5.2.5 The list in paragraph B5.2.4 is not exhaustive. An entity shall use all information about the performance and operations of the investee that becomes available after the date of initial recognition. To the extent that any such relevant factors exist, they may indicate that cost might not be representative of fair value. In such cases, the entity must measure fair value.”

From the above, the Committee notes that the investments in equity instruments falling within Ind AS 109 are to be measured at fair value; however, as per the requirements of paragraphs 4.1.4 and 5.7.5 of Ind AS 109, an entity may make an irrevocable election at initial recognition for particular investments in equity instruments that would otherwise be measured at fair value through profit or loss to present subsequent changes in fair value in other comprehensive income. Further, paragraph D19B of Ind AS 101, ‘First-time Adoption of

Indian Accounting Standards' gives an option to designate an investment in an equity instrument as at fair value through other comprehensive income in accordance with paragraph 5.7.5 of Ind AS 109 on the basis of the facts and circumstances that exist at the date of transition to Ind ASs. Accordingly, since such an option has been elected by the Company for the investments in equity instruments of A Corporation Ltd. in the extant case, the subsequent measurement of such investments at fair value through OCI is correct. Further, the Committee notes that as per Ind AS 109, all investments in equity instruments are to be measured at fair value irrespective of whether these are quoted or not quoted in an active market except in limited circumstances, where cost may be an appropriate estimate of fair value, as per paragraphs B5.2.3 to B5.2.5.

11. With regard to measurement of investment in A Corporation Ltd. at fair value, the Committee notes that as per the requirements of Ind AS 109, fair value has to be determined as per the requirements of Ind AS 113, 'Fair Value Measurements'. Therefore, the Committee notes the following requirements of Ind AS 113:

“Definition of fair value

9 This Ind AS defines 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.”

“3 When a price for an identical asset or liability is not observable, an entity measures fair value using another valuation technique that maximises the use of relevant *observable inputs* and minimises the use of *unobservable inputs*. Because fair value is a market-based measurement, it is measured using the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk. As a result, an entity's intention to hold an asset or to settle or otherwise fulfil a liability is not relevant when measuring fair value.”

“The transaction

15 A fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date under current market conditions.”

“Valuation techniques

61 An entity shall use valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value, maximising the use of relevant observable inputs and minimising the use of unobservable inputs.

62 The objective of using a valuation technique 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. Three widely used valuation techniques are the market approach, the *cost approach* and the income approach. The main aspects of those approaches are summarised in paragraphs B5-B11. An entity shall use valuation techniques consistent with one or more of those approaches to measure fair value.

- 63 In some cases a single valuation technique will be appropriate (eg when valuing an asset or a liability using quoted prices in an active market for identical assets or liabilities). In other cases, multiple valuation techniques will be appropriate (eg that might be the case when valuing a cash-generating unit). If multiple valuation techniques are used to measure fair value, the results (ie respective indications of fair value) shall be evaluated considering the reasonableness of the range of values indicated by those results. A fair value measurement is the point within that range that is most representative of fair value in the circumstances.
- 64 If the transaction price is 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 result of the valuation technique equals the transaction price. ... After initial recognition, when measuring fair value using a valuation technique or techniques that use unobservable inputs, an entity shall ensure that those valuation techniques reflect observable market data (eg the price for a similar asset or liability) at the measurement date.”

“Fair value hierarchy

- 72 To increase consistency and comparability in fair value measurements and related disclosures, this Ind AS establishes a fair value hierarchy that categorises into three levels (see paragraphs 76-90), the inputs to valuation techniques used to measure fair value. The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1 inputs) and the lowest priority to unobservable inputs (*Level 3 inputs*).”

“Level 1 inputs

- 76 Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date.
- 77 A quoted price in an active market provides the most reliable evidence of fair value and shall be used without adjustment to measure fair value whenever available, except as specified in paragraph 79.”

“Level 2 inputs

- 81 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.
- 82 If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability. Level 2 inputs include the following:
- (a) quoted prices for similar assets or liabilities in active markets.
 - (b) quoted prices for identical or similar assets or liabilities in markets that are not active.
 - (c) inputs other than quoted prices that are observable for the asset or liability, for example:
 - (i) interest rates and yield curves observable at commonly quoted intervals;

- (ii) implied volatilities; and
 - (iii) credit spreads.
- (d) *market-corroborated inputs.*”

“Level 3 inputs

- 86 Level 3 inputs are unobservable inputs for the asset or liability.
- 87 Unobservable inputs shall be used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. However, the fair value measurement objective remains the same, ie an exit price at the measurement date from the perspective of a market participant that holds the asset or owes the liability. Therefore, unobservable inputs shall reflect the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk.”
- “89 An entity shall develop unobservable inputs using the best information available in the circumstances, which might include the entity's own data. In developing unobservable inputs, an entity may begin with its own data, but it shall adjust those data if reasonably 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 (eg an entity-specific synergy). An entity need not undertake exhaustive efforts to obtain information about market participant assumptions. However, an entity shall take into account all information about market participant assumptions that is reasonably available. Unobservable inputs developed in the manner described above are considered market participant assumptions and meet the objective of a fair value measurement.”

From the above, the Committee notes that as per the requirements of Ind AS 113, when measuring fair value, the objective is to estimate the price at which an orderly transaction to sell an asset or to transfer a liability would take place between market participants at the measurement date under current market conditions.

The Standard states that there are three widely used valuation techniques, viz., the market approach, the cost approach and the income approach. The Standard prescribes to use valuation techniques consistent with one or more of these approaches to measure fair value; and that are appropriate in the circumstances and for which sufficient data are available to measure fair value, maximising the use of relevant observable inputs and minimising the use of unobservable inputs. In some cases, a single valuation technique will be appropriate, while in other cases, multiple valuation techniques will be appropriate. Further, the Standard states that the availability of relevant inputs and their relative subjectivity might affect the selection of appropriate valuation techniques. However, the fair value hierarchy prioritises the inputs to valuation techniques, not the valuation techniques used to measure fair value. Ind AS 113 also establishes a fair value hierarchy that categorises into three levels, the inputs to valuation techniques used to measure fair value. The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1 inputs) and the lowest priority to unobservable inputs (Level 3 inputs). Thus, the Standard does not

prescribe the use of a specific valuation technique or a hierarchy of valuation techniques; rather it only provides a hierarchy of inputs to valuation techniques.

12. From the above, the Committee notes that the fair valuation involves judgement not only when applying a valuation technique, but also in the selection of valuation technique. However, whichever approach or technique(s) is used, the objective of fair valuation should be kept in mind, i.e. an exit price at the measurement date from the perspective of a market participant that holds the asset.

13. In this context, the Committee notes that the investment in the extant case is made in A Corporation Ltd., which is a closely held company and not a listed company and hence level 1 inputs may not be available. Accordingly, as per the above-mentioned requirements of Ind AS 113, the Company should use level 2 inputs (i.e. observable inputs such as quoted prices of similar assets in active market or in markets that are not active, interest rates and yield curves observable at commonly quoted intervals, implied volatilities, credit spreads market corroborated inputs, etc.) or if these are not available, the Company should use Level 3 inputs that are unobservable inputs. However, the fair value measurement objective, as discussed above, should be kept in mind. Therefore, unobservable inputs shall reflect the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk. Further, the Company can develop unobservable inputs using the best information available in the circumstances, which might include the Company's own data, but it shall adjust those data if reasonably 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 (eg an entity-specific synergy).

Further, where such unobservable inputs are used to measure fair value, as per paragraph 64 of the Standard, if the transaction price is 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 should be calibrated so that at initial recognition the result of the valuation technique equals the transaction price.

14. Thus, in spite of A Corporation Ltd. being an unlisted company and absence of availability of observable market transactions and other market information, the Company should determine the fair value considering its specific facts and circumstances using valuation technique(s) and using one or more observable and unobservable inputs; and keeping in view the objective of fair value measurement and other requirements of Ind AS 113. However, the Committee notes that in the extant case, the Company has apparently taken its share in the net book value/carrying amount of net assets of A Corporation Ltd. as on the reporting date as a substitute of fair value. The Committee is of the view that while determining fair value, net book value/carrying amount of net assets could be used as the beginning point or as one of the inputs, which may require further adjustments as per valuation technique(s) considering the requirements of Ind AS 113, but the same itself cannot be directly considered as substitute of fair value. Therefore, since the Company has not apparently followed the above approaches, techniques and methodology prescribed under Ind AS 113 to determine fair value in the extant case, the same is not appropriate.

D. Opinion

15. On the basis of the above, the Committee is of the view that since the option under paragraph D19B of Ind AS 101 has been elected by the Company for the investments in equity instruments of A Corporation Ltd. in the extant case, the subsequent measurement of such investments at fair value through OCI is correct, as discussed in paragraph 10 above.

With regard to the method of valuation, the Committee is of the view that the Company should determine the fair value considering its specific facts and circumstances using valuation technique(s) and using one or more observable and unobservable inputs; and keeping in view the objective of fair value measurement and other requirements of Ind AS 113. However, in the extant case, the Company has apparently taken the share in the net book value/carrying amount of net assets of A Corporation Ltd. as on the reporting date as a substitute of fair value. The Committee is of the view that while determining fair value, net book value/carrying amount of net assets could be used as the beginning point or as one of the inputs, which may require further adjustments as per the valuation technique(s) considering the requirements of Ind AS 113, but the same itself cannot be directly considered as substitute of fair value. Therefore, since the Company has not apparently followed the above approaches, techniques and methodology prescribed under Ind AS 113 to determine fair value in the extant case, the same is not appropriate.

With regard to using 'cost' as the basis of valuation of equity instruments, the Committee is of the view that as per paragraphs B5.2.3 to B5.2.5 of Ind AS 109, all investments in equity instruments are to be measured at fair value irrespective of whether these are quoted or not quoted in an active market except in limited circumstances, where cost may be an appropriate estimate of fair value.
