IOSR Journal of Business and Management (IOSR-JBM)
e-ISSN: 2278-487X, p-ISSN: 2319-7668
PP 124-131
www.iosrjournals.org

Impact of VUCA on Fair Value Accounting

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Abstract: *Fair value accounting necessitates considerable subjectivity and judgment. The expected unbiased and rational approach towards fair value accounting poses real challenge in VUCA world. With the implementation of International Financial Reporting Standards (IFRS), in the form of IND-AS in April 2016, the requirement of fair value accounting and related disclosures have grown manifold. IAS 39 deals with recognition and measurement of Financial Instruments. The requisite of the standard to measure the fair value of the financial instrument is largely influenced by the volatility in markets. Accounting treatment for Plant, Property and Equipment under Ind-AS 16 has inherent Complexity such as componentization, periodic revaluation, etc. Accounting for Business Combination, pre and post the event, under Ind-AS 103 is largely affected by Uncertainty element. All these factors, together with inherent subjectivity in the application of Fair Value contribute to considerable ambiguity in the minds of the investors. The research tries to portray impact of VUCA on the fair value accounting. The paper aims to identify corporate understanding on fair value accounting in VUCA world and its efforts to respond to it.*

Keywords: *Accounting, Fair Value, IFRS, Ind-AS, Reporting*

I. Introduction

The decision of Government of India to align Indian financial reporting with International Standards and thus, adoption of Ind AS led to certain challenges for Indian corporates. Transition to Ind AS necessitated significant changes in reporting framework to enhance comparability of Indian financial statements. Certain key areas such as Ind AS 32, Ind AS 109, and Ind AS 107 related to Financial Instruments and disclosure, compelled use of fair valuation at each reporting date with changes being recognized in the income statement. It involves dependency on certain uncontrolled factors such as quoted price of similar instruments in the market and deciding the benchmark based on that, exposes the estimation of fair value to market volatility and subjectivity. The revaluation model of tangible assets under Ind AS 16 involves ascertaining Fair Value on the reporting date, materially useful life, and terminal value, all of which is practically very uncertain. Ind AS 103 Business Combination uses the concept of fair value for accounting assets and liabilities to measure the cost of business which is extremely complex due to cross-holdings and nature of business operations.

Overall these new requirements have contributed to considerable ambiguity since, each of them involves lot of judgement and estimation.

The study here revolves around VUCA in terms of Financial Reporting and understanding how far the corporate world has been able to adopt and sustain the changes due to implementation of Ind AS.

II. Conceptual Framework

1.1 Volatility: Volatility is constant change in uncontrolled factors such as market prices, demand or supply of commodities, interest rates, foreign currency rates, systematic risk factors etc. World is volatile hence, dynamic. Volatility leads to risk of failure or negativity. To quote an example, in case of company having 90% imports in its COGS, entire profit margin may get eroded due to adverse movement in unhedged foreign currency. If we can control or bring in predictability to the financial forecast then, we can curtail the risk due to volatility.

1.2 Uncertainty: Uncertainty is unpredictability of the future due to intervention of unknown factors. In financial terms, annual budget is prepared based on certain assumptions or estimations, which are uncertain and hence, there are cases of deviation in reality than the budget. To explain in general terms, we don't have control on death. The situation such as actress Sridevi's death due to accidental drowning was completely uncertain.

1.3 **Complexity:** Complex means difficult. Absence of clarity makes the situation complex and leads to confusion. In case of complex derivative instruments, wherein the attractive returns click the derivative deals faster while underlying risk factor remains unascertained due to complexity. It ultimately leads to credit default or erosion of net worth. In another instance, government of India implemented Goods & Services Tax (GST) to reduce the complexity in Indian Taxation system to create ease in business.

1.4 **Ambiguity:** Ambiguity arises due to different perspective of the user. Typically when the situation involves volatility, uncertainty and hence complexity, it becomes ambiguous or vague in nature and thus, loses transparency. In simple terms, in English language same word has different connotations. In the absence of clarity of the expected meaning by the writer, the user is at his / her discretion to use the meaning of the word.

1.5 **Financial Reporting:** Various stakeholders including management is keen in knowing the financial performance of the organization. The essence of any business is its profitability. Hence, contribution of individual departments in any organization is finally consolidated and presented to the stake holders in financial terms, which is known as Financial Reporting. To create common understanding platform amongst the users, financial reports are prepared based on the accounting standards.

1.6 **Indian Accounting Standards (Ind-AS):** India was following Indian Generally Accepted Accounting Standards (IGAAP) before 1st April, 2016. The necessity to align with the global standards to make Indian financial statements transparent and uniform and hence, acceptable globally, India adopted Ind-AS, converged with International Financial Reporting Standards (IFRS), effective April 2016. This change is expected to gain more confidence in foreign investors in Indian economy and thereby welcoming more business opportunities for India.

1.7 **Fair Value:** We normally use phrase, "everything is fair in love and war" which means acceptable. Fair Value means acceptable price of the product or service. Acceptable means reasonable and not inflated or deflated value. It's also known as "Arm's length price" which might be fixed between the parties to the transaction for buying and selling of particular product or service. Ind-As 113 provides guidance regarding how to measure fair value of financial or non-financial assets and liabilities. The areas, where Fair Value is most relevant, are Financial Instruments, Plant/Property/Equipment and Business Combinations.

1.8 **Financial Instruments:** It's a device or a document carrying monetary value and legal significance. The securities such as equity, bond, deposits, mutual funds, cash equivalents etc. are treated as financial instruments. Owner of the financial instrument has the legal right to liquidate it in the exchange of money. Ind AS 32, Ind AS 109, and Ind AS 107 related to Financial Instruments and disclosure, articulate the financial reporting requirements for financial instruments. Fair value plays crucial role in initial recognition and subsequent measurement of the Financial instruments.

1.9 **Business Combination:** Combining the businesses to grow multifold. The businesses normally acquire another business to either grow in same line of products or services to raise the market share or to diversify the business to expand the portfolio. Sometimes business combination helps the organizations towards backward or forward integration and to achieve related cost benefit along with expansion. Ind-AS 103 provides guidance related to business combination transactions and relevant financial disclosures. In case of acquisition method, it is imperative to calculate the Fair Value of assets, liabilities and contingent liabilities on the relevant date.

1.10 **Property, Plant, Equipment (PPE):** These are the tangible or fixed assets of any business which are difficult to liquidate quickly. It is necessary to identify the life of individual asset and the residual or terminal value in order to decide annual amortization in the value of such asset. Ind-AS 16 describes the componentization approach which is distinct from the past practices in the recognition of the fixed asset in the books of accounts.

III. Literature Review

a. Deloitte Co. (2016) in their circular said that effective Ind AS conversion would require significant input from practically every business unit and link in the decision-making and value-generating chain, including IT, HR, finance, treasury, product development, underwriting, benefits / claims payout, reinsurance, reserving, distribution, marketing and customer service. Without careful preparation, the volatility of reported results could reach unexpected levels and the level of execution risk may become unsustainable. Ind AS is likely to increase income volatility, which certainly needs to be managed, or at least carefully explained to the stakeholders, to avoid undermining their confidence. Also, Management Information Systems may need to be revamped and economic capital and other common value-at-risk measurements reassessed as the current strategies could prove untenable. For successful implementation, there is large amount of time commitment that insurers will have to invest as there are significant process and information challenges associated with the adoption of these standards. So, it is imperative that the implementation is done right, the first time. Adoption of Ind AS also presents an opportunity to insurers to recast their financial position and operating results on a globally recognised set of accounting pronouncements. This opportunity calls for a high degree of strategy in developing a framework for individual decisions. This framework should focus on the interplay between opening Ind AS equity and the potential for volatility in future earnings.

b. Igor Goncharov (2015) tried to analyse relation between volatility in fair value accounting vis-à-vis volatility in share prices based on the findings of UK Investment Trust. The comparative study between two aforesaid elements highlights which element is more sensitive and its effect on the overall risk assessment and decision making of the investor. The author has also pointed out the need of accuracy in the estimation of the fair value.

c. Solomonzori, (blog entry, December 19, 2012) confessed that the adoption of IFRS to suit the local requirements has led to different versions of IFRS across borders. The ambitious move of the law makers to bring in uniformity while transacting beyond the country, through implementation of single accounting standard, that is IFRS, has been defeated to that extent due to country specific accounting standards and timing to adopt the same. Overall this has led to lot of ambiguity in the minds of the stakeholders.

d. KPMG (Issue 14/2017, September 2017) describes the necessity of considerable judgment in identifying significant component of PPE, as mandated by Ind AS-16. Also, promulgated the challenges in ascertaining the component and cost allocation to that in order to meet the regulatory requirements. While providing the guidance on the subject, the firm has distinctly indicated the complexity involved with respect to the component accounting and amortisation.

IV. Objectives & Hypothesis

4.1 Objectives-

4.1.1 To identify various VUCA Components affecting Ind-AS which require the applicability of Fair Value concept more extensively.

4.1.2 To elaborate how they affect the reporting requirements of the company.

4.1.3 To undertake a dipstick research with few Indian companies to gauge their response to implementation of Fair Value Accounting principles.

4.2 Hypothesis-

H_1: There is no significant association between component approach, as required by Ind-AS 16, and 4 types of sectors.

H_2: There is no significant association between fair value accounting for financial instruments, as required by Ind AS 32, Ind AS 109, and Ind AS 107, and 4 types of sectors.

H_3: There is no significant association between accounting for business combination, as required by Ind-AS 103, and 4 types of sectors.

V. Research Methodology

The study is based on the primary survey covering representative corporates from FMCG, Financial Services, Pharma, and Manufacturing sectors. The research considers inputs from twelve corporates with respect to fifteen questions. The questionnaire largely covers the questions based on accounting standards on Financial Instruments - Ind AS 32, Ind AS 109, and Ind AS 107, Property, Plant and Equipment - Ind-AS 16 and Business Combination - Ind-AS 103 and tries to find out corporate readiness towards changes in accounting practices due to implementation of aforesaid accounting standards and inbuilt VUCA factor in the accounting standards. This is a dipstick reseach, based on convenient sampling. Questionnaire consisted of 15 questions asked across four sectors, as mentioned above.

In the analysis, questions are clustered around each component of the VUCA and the respondents are grouped as per industry. In each of the cluster as well as group and in totality, it is established as to how many percentage of the responses are scored 4+, i.e. Agree and Totally Agree.

VI. Data Analysis.

		FIN SERV	MFG	SERVICE	INFRA		TOTAL
VOLATILITY	Total Count	9	12	9	6		36
	>4 Count	4	9	5	4		22
	%	44.44%	75.00%	55.56%	66.67%		61.11%
UNCERTAINTY	Total Count	12	16	12	8		48
	>4 Count	4	8	5	4		21
	%	33.33%	50.00%	41.67%	50.00%		43.75%
COMPLEXITY	Total Count	12	16	12	8		48
	>4 Count	6	10	6	5		27
	%	50.00%	62.50%	50.00%	62.50%		56.25%
AMBIGUITY	Total Count	12	15	12	8		47
	>4 Count	4	7	4	3		18
	%	33.33%	46.67%	33.33%	37.50%		38.30%
Total	Total Count	45	59	45	30		179
	>4 Count	18	34	20	16		88
	%	40.00%	57.63%	44.44%	53.33%		49.16%

As can be seen from the aforesaid table, the over-all perception of the respondents is that corporate is not completely prepared to deal with the VUCA environment and reporting in Fair Value Measurements. This is evidenced from the over-all positive response slightly less than 50%. This is typically because of the lower percentage in uncertainty and ambiguity factors, which the corporates perceive difficult to deal with. Comparatively, Volatility and Complexity are considered manageable by the respondents.

Similarly, Manufacturing and Infrastructure industries are more prepared to deal with the VUCA world, as opposed to Financial & general services sector.

However, it is worth noting that the 24.58% responses are 'Neither Agree nor Disagree'. If one eliminates them, one realizes that close to two-third of the responses would be positive. Thus, it can be inferred that corporate is not entirely unprepared to deal with VUCA environment..

VII. Limitations

6.1 The paper undertakes only dipstick survey and not an extensive one. Thus, large part of the corporate may not be covered here.

6.2 There are no clearly identified indicators of various VUCA Compnents, such as Volatility or Ambiguity. As such, quantified correlation is not possible.

6.3 The application Ind-AS being recent phenomenon, needs to mature further for better understanding.

VIII.Relationship Of V U C A And Ind-As

As elaborated earlier, Fair Value Accounting and the reporting generated out of it, is a recent phenomenon for the Indian corporate. The erstwhile accounting standards started to align themselves with the global model almost a decade back. Yet, it was from the Financial Year 2016-17 that the completely IFRS-converged set of Indian Accounting Standards, Ind-As was actually required to be followed for accounting. This provision, too, is applicable only to selective companies[1]. Here is a brief discussion about VUCA vis-à-vis Fair value reporting…

7.1 Volatility & Financial Instruments – Volatility in capital market is nothing new. Yet, the capital markets of contemporary times are so interlinked that the resulting volatility is manifold today, than ever before. This is because the macro economic factors, affecting the market performance are wide in numbers as well as controlled themselves by too many other variant factors. For fair value measurement, the level one input is market data. In case of market traded financial instruments, it is easier to obtain such a data. However, if the instruments are not traded in market and consequently, no inputs are available at Level One, the reporting has to be on the basis of Level Two, i.e. Observable Inputs. The Volatility in the markets obscures the effectiveness of this methodology of measurement. Insofar as Indian stock markets are concerned, they are affected by factors, ranging widely from US Fed Reserves Rates, International Oil Prices to Elections held in a crucial state or scams unearthed in a particular branch of one bank. This makes it difficult to rely on the market data/level one inputs for Fair Value. For observable inputs, the government policies on money market rates are important. However, one of the toughest task in fair value measurement for the reporting is to arrive at Cost of Capital of the entity. This task is made complicated sue to volatility in Bank Rates, Lending norms and rates, existence of black market economy and fluctuations in profitability. Besides, Financial Instruments such as embedded derivatives or knock out option are severely affected by market volatility for their measurement.

7.2 Uncertainty and PPE: Plant, Property & Equipment, in other words, tangible assets of the business are most crucial for its growth and need to be reported as best as they can be. Ind- AS has given option of reporting them based on Revaluation Model, as opposed to Historic Model, that was followed earlier (though Revaluation Model was an option provided in earlier Accounting Standard, it was introduced later). In this model, the Fair Value needs to be calculated on the reporting date. This might be relatively easier but it is more difficult to ascertain the Useful Life of an Asset. One reason of this Uncertainty is the era of technological avalanche that we live in. this makes it difficult to claim with certainty that a particular machine, though in fine working condition, may not become technologically obsolete, in shorter time. Further, the scrap value of the asset is needed to be ascertained, be arriving at fair value of the asset used for the same life span that the reporting asset is expected to be used for, at the moment. In this process, it is largely uncertain that the machine that has used up say 10 years of life today, shall have same value as the machine that has used up 10 years of value after 5 years. Componentization, is another issue that has added to uncertainty of reporting in PPE. Thus, it would be tough task for accountants to identify which components shall have a separate life than the integrated machine and accordingly account for them.

7.3 Complexity and Business Combinations: Fair Value is required to be applied to calculate the value of assets and liabilities acquired. However, when the acquisition is on Unit basis, it would be complex to delineate the unit with business as a whole. Further, the assets and liabilities might be linked with other factors unrelated to the main combination process. This complexity is owing to modern business structuring which has created complicated models of business structuring such as reverse acquisition.

However, it must be noted here that various factors in VUCA do not necessarily apply in the limited way as exposed earlier. Componentization process in measuring PPE under Ind-AS 16 is not merely uncertain but even complex. The fair value measurement of assets and liabilities is marred by uncertainty as well, since it requires corporates to consider sensitivity analysis of future uncertain cash flows. The whole segment of financial instrument is complex due to newer financial products as mentioned aforesaid, uncertain due to reporting irregularities such as off balance-sheet items and complex in their very structuring, such as convertibility.

Here, then, is the crucial question... Do these factors make Financial Reports ambiguous? On the surface of it, Ind-AS are designated to be 'Fair' in nature, meaning closer to the True nature of the transaction rather than the form in which it is garbed. This necessitates several disclosures, disclaimers and such other ancillary information as required, composed in the Notes to Account Section. If one has to go through all of these notes, one would certainly find the report far more ambiguous than they were before. This is mainly due to subjectivity introduced in the measurement of reporting values. Yet, this subjectivity is inevitable if one goes by the very ethos of the term 'Fair Value'. This subjectivity is further influenced by the volatility of markets form which Fair vaue is drawn, complexity of business environment that has emerged out of international business interaction and uncertainty in the major factors which determine trade and commerce. The composite effect of all this is clarity in figures, but ambiguity in their understanding, comparability and conclusiveness.

IX.Corporate Response To Vuca

How is the corporate reacting to this? We undertook a dipstick survey to ascertain the mood of the corporate on this front. Here are brief finding of our survey...

8.1 Research methodology: 5 point Likert Scale questionnaire, which elicits responses from Strongly Disagree to Strongly Agree. The Values are 5 to 1, from 5 being the value for Strongly Agree. The response of Strongly agree denotes the impression of the respondent towards the belief that the Indian Corporate is prepared fully to deal with the VUCA and Fair Value interface.

8.2 Respondents: the respondents are senior managerial personnel from eminent corporate across different industry sections, such as pharmacy, infrastructure and financial services. It should be noted here that the survey is dipstick and based on random statistical sampling techniques.

8.3 Finding:

8.3.1 The median values of the questions are largely on the agreement side, reflecting that most of the respondents believe that the Indian corporate is ready to deal with the issues of VUCA

8.3.2 Interestingly, the median is relatively lower in case of Uncertainty and Ambiguity aspect, as opposed to volatility and complexity.

8.3.3 Over all, the mean values are between 3 and 4, indicating that the respondents agree with the statement suggesting that they are capable of dealing with VUCA situation, but only just so!

8.3.4 The median values of some particular questions throw interesting light. E.g. the respondents strongly believe that the fair value improves comparability, thus showing their confidence in dealing with the complexity. However, on the other hand, they do not believe that the reliable market data is available to deal with uncertainty and volatility. They also do not believe that the corporate or reporting community has studied the antecedents of fair value implementation enough. Most importantly, they strongly disagree that the necessary inputs are available for the ascertaining of Fair value.

X.Conclusion And Recommendations

VUCA is the fact of modern Corporate Environment. It is not necessarily a challenge but also an opportunity. Yet, any sustainable corporate growth is possible only when there is 'True & Fair' reporting of the performance by corporate. This, in turn, is possible if the reporting community comprehends the challenges of the VUCA world and harnesses them to strive towards fairer reporting. This, in itself, is an opportunity for the reporting professionals. For this, it is essential for the reporting professionals to draw constantly upon the available data bank that can help project coming challenges, something they themselves do not believe them to be good at!

Ultimately, as is clear from the responses, matured markets and constant flow of information are big requirements for such reporting! On one hand, stronger regulatory framework may help in emergence of such markets whereas on the other, responsible reporting can itself become a good source of reliable information...

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Annexure – Questionnaire

Sr. No.	Questionaire on Fair value accounting	Strongly agree	Agree	Neither Agree nor Disagree	Disagree	Strongly Disagree
1	Despite the significance of the volatility in the fair value of the underlying items of PPE, annual revaluation shall be preferred over triannual or quinquennial (once in five years) revaluation.					
2	Companies have built up the necessary knowledge base to analyze the contracts for embedded derivatives and appropriately apply the recognition principles as specified by Ind AS 109.					
3	The classification of Financial Instruments under the new nomenclature would be carried out judiciously by the companies.					
4	Indian corporate significantly lack in the knowledge pertaining to the earlier experiences of the implementation of Fair Value Reporting					
5	Chartered Accountants have largely studied the impact of Fair Value Concept in the reporting that led to sub prime crisis					
6	Due consideration shall be given to the impact of Fair Value Accounting in Enron debacle, while assessing the Fair Values in the reporting of Indian Corporates					
7	In several cases, Sufficient Inputs are not be available to ascertain the Fair Values					
8	Indian Corporate Environment significantly lacks to provide necessary inputs for Fair Value measurement.					
9	Sufficient information is available to estimate residual value at the end of every financial year in case of PPE.					

Sr. No.	Questionaire on Fair value accounting	Strongly agree	Agree	Neither Agree nor Disagree	Disagree	Strongly Disagree
10	Reliable Market data is available while ascertaining the Fair Value of the Financial Instruments					
11	Fair Value Accounting significantly improves the comparability of the Financial Statements in Global context.					
12	The subjectivity in the adoption of Fair Value shall not hinder its comparability.					
13	Indian Corporates have developed the suitable structures of Corporate Governance to ensure the most transperant and efficient applicability of Fair Value Accounting.					
14	Auditors shall be able to synchronise effectively with the Corporate Finance departments of the companies to agree upon the adopted Fair Values.					
15	It will be easier for the Government to identfy the manipulation and discripancies in Measurements based on Fair Value					