

Fair Value Measurement – a Challenging Path in Emerging Economies

Indonesia's Perspectives

HUT IKATAN AKUNTAN INDONESIA KE 55

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Background - Fair Value Accounting & The Current Economic Crisis

Case of US Collateralized Debt Obligation (CDOs)

- In the late 1990s : the US federal government institutes policies that SP lending is a social policy
- In the late 2006: an increase in general level of interest rates caused sharp rise in delinquencies and default rates by SPM borrowers
- Simultaneously this has brought rating agencies to significantly downgraded the SPM securities that cause investors and lenders to refrain from investing in CDOs
- The lack of secondary market has created a 'liquidity crisis'

Background (cont'd)

At the center of the liquidity crisis is an accounting issue;

1. How to measure the securities in the financial reporting?
 1. Fair Value
 2. Available for sale (AFS)
 3. Held to maturity (HTM)
2. At what level in the fair value hierarchy is the fair value measurement when the market is considered distressed?

Opinion of Center for Audit Quality, Council of Institutional Investors and CFA Institute

- *Suspending fair value accounting during these challenging economic times would deprive investors of critical financial information when it is needed most. FV Accounting with robust disclosures provides more accurate, timely and comparable information to investors than amounts that would be reported under other alternative accounting approaches. Investors have a right to know the current value of an investment, even if the investment is falling short of past or future expectations.*

The Agenda

- Introduction to IFRS 13
- Emerging Economies – definition and problem
- Valuation for Financial Reporting – the needs to measure Fair Value
- The concept, definition and application of FV
- FV Hierarchy and Valuation Method
- HBU for Non Financial Assets
- IVS & SPI
- Related Issues
- Road Map

Introduction

- IFRS 13 Fair Value Measurement has been recently released by the IASB and effective for annual periods beginning on or after 1 January 2013
- IVS (International Valuation Standards) 2011 has been published in 19 July 2011 and effective in 1 January 2012. The new standards are the result of a three year improvement project undertaken by the IVSC Standards Board. The new standards aim to increase confidence in valuations through **promoting consistency and transparency throughout the valuation process.**
- Indonesia through MAPPI is a member of IVSC and targeted to conform with the new IVS in 2012.

Overview and background

IAS 16

IAS 36

IAS 39/IFRS 9

IAS 40

IAS 41

Etc.

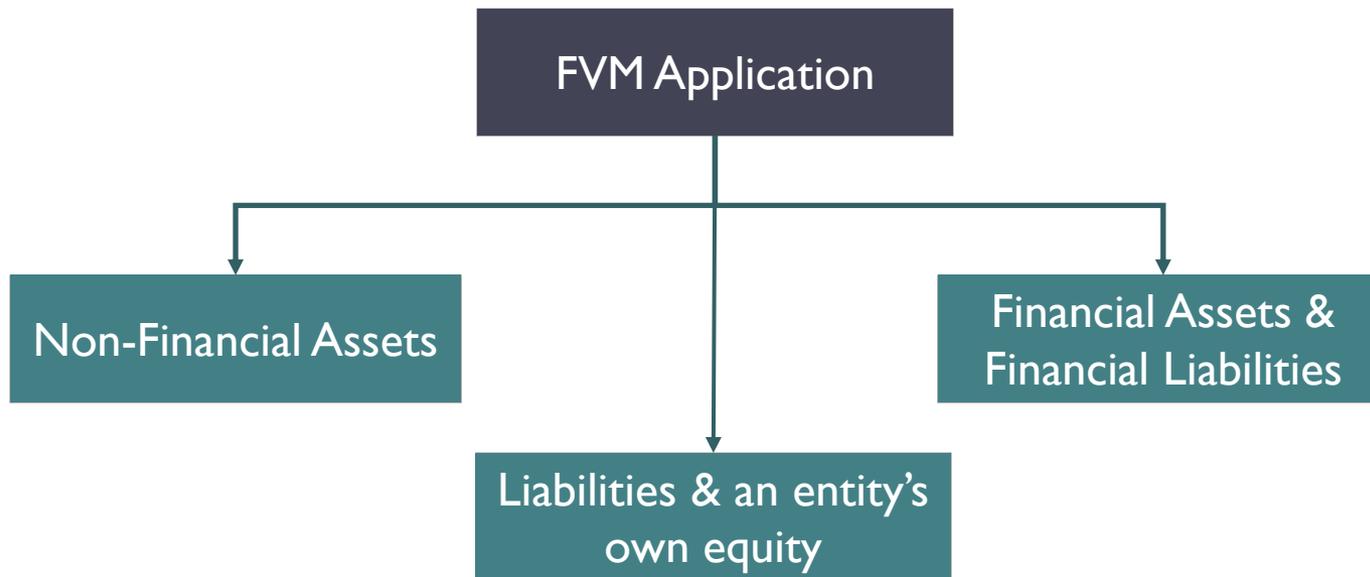
Topic 820 in US GAAP (codified SFAS 157)

IFRS 13

- Single source of measurement and disclosure requirements
- Clear measurement objective
- Does not specify what is to be measured at fair value
- Effective 1 Jan 2013 (earlier application permitted; prospective transition)

Source: Hillary Eastman, IASB

Fair Value Measurement



Emerging Market definition

A market growing in size and sophistication and found in national economy, which in **transition** to becoming more developed and **market-based**.

An emerging market may be a financial market with a short operating history and/or a low level of capitalisation.

Common characteristics to EM; rapid development of political, legal and institutional frameworks; transitioning from a planned or command economy to a **market-based economy**.

- *As a result emerging markets are becoming increasingly **globalised**.*

Emerging Economies Problems

The special economic, legal and institutional characteristics of emerging market pose particular problems for Valuers which include:

- ✓ A poor and inadequate legal framework that does not allow for the efficient functioning of the property market
- ✓ The lack of published information or difficulty in obtaining information regarding transactional as well as other data requisite for proper valuation
- ✓ Greater market volatility
- ✓ Excessive or insufficient government intervention
- ✓ Growing importance of intangible property

Role of adequately trained professional Valuers

- The central role of professional Valuers are essential in the efficient functioning of the global financial market and needs to be better understood and appreciated by users of valuation services, the regulators, the government and the general public.

Valuation for Financial Reporting

- Key Principles
 - Valuers must understand the relationship between valuation and accounting standards and between International Accounting Standards (IFRS) and national accounting standards (PSAK)
 - ✓ Scope of work
 - ✓ Valuation assumptions & analysis
 - ✓ Reporting

Definition of Fair Value

IFRS 13 :

“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 (i.e., an exit price)”

PSAK 16 :

“The amount at which an asset could be exchanged between knowledgeable, willing parties in an arms length transaction”

IVS/SPI :

“The estimated price for the transfer of an asset of liability between identified knowledgeable and willing parties that reflects the respective interests of those parties”

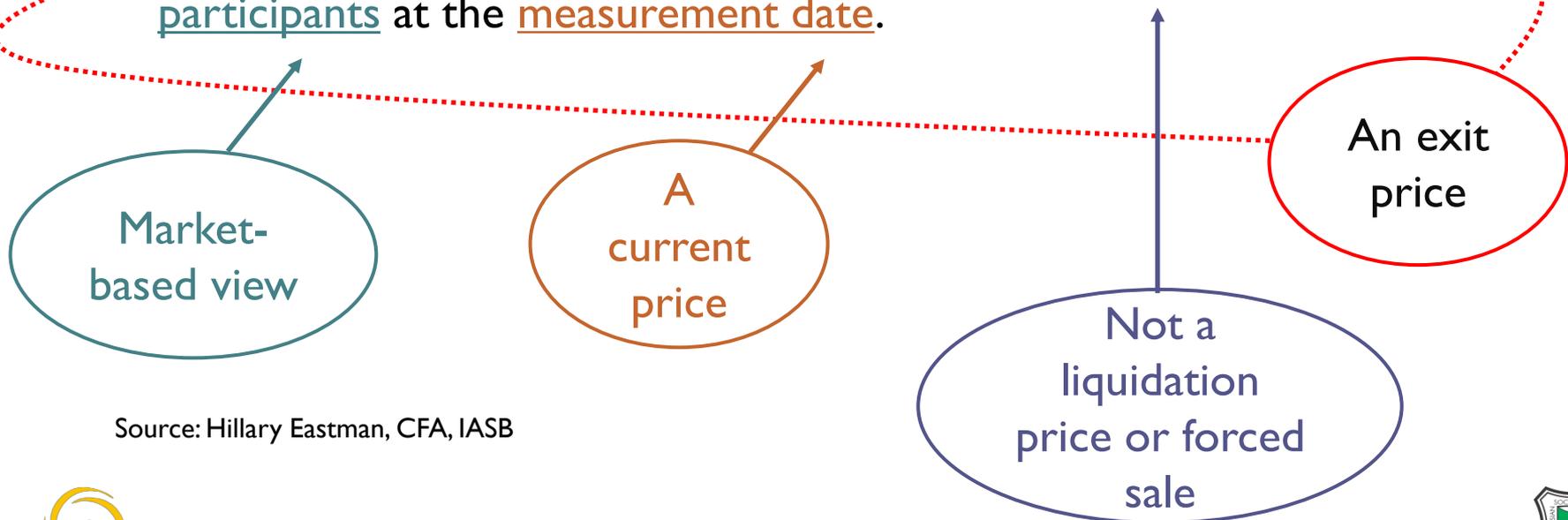
Market Value

“The estimated amount for which an asset should exchange on the date of valuation between a willing buyer and a willing seller in an arm’s length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion”

Definition of fair value

What is the measurement objective?

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.



Source: Hillary Eastman, CFA, IASB

Comments

- the definition of FV in IFRS 13 is generally consistent with MV in IVS
- definition of FV in IVS 2011 is a broader concept than MV and is used **for purposes other than financial reporting, i.e.; litigation purpose**
- the latest concept of FV will call for revision of PSAK and SPI (national standard) Valuation for financial reporting, since **it only accepts value in exchange and not value in use** where the advantages that would not be available to market participants is generally to be disregarded.

Fair Value application

Financial Reporting

Carrying amount measurement, Purchase Price Allocation, Impairment Testing, Lease Classification, Financial Instruments, Depreciation calculation, etc

Mergers & Acquisition (M&A)

Pricing of the Target, Selling of single intangibles to third parties

Tax Purposes

Change of Ownership, Licensing in/out, Transfer Pricing

Value Management & Value Reporting

Intellectual Asset Management, Controlling, Public Relations

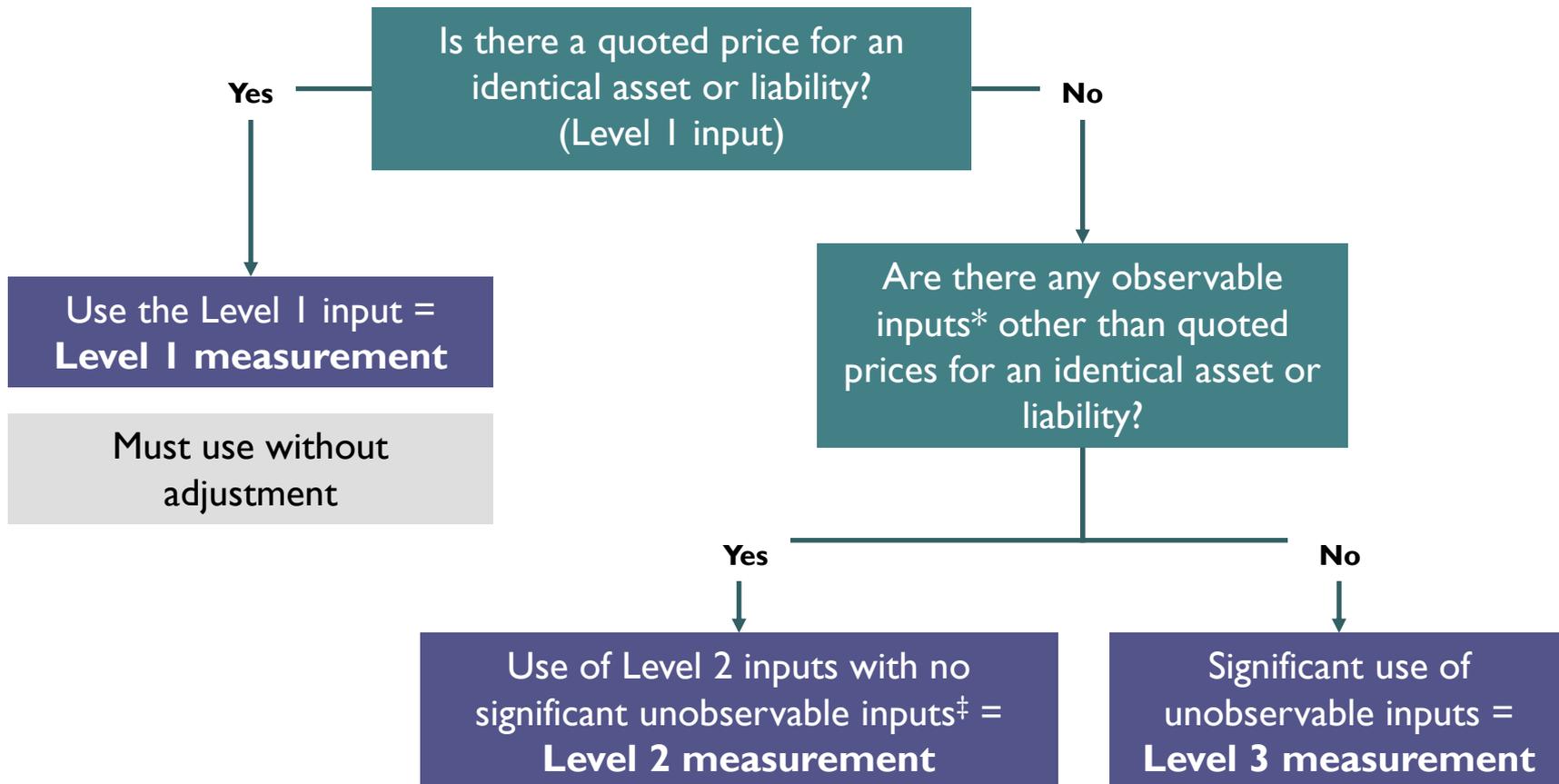
Financing & Securitization

Rating, Start-up Financing, Sales & Lease Back, Security for Creditor

FV Hierarchy & Application

Level 1	Quoted prices (unadjusted) in active market for identical assets and liabilities that the entity can access at the measurement date	N/A for non financial assets
Level 2	Observable inputs other than quoted prices in level 1, either directly (ie, as prices) or indirectly (ie, derived from prices)	In active and transparent market, if no significant adjustments is made
Level 3	Unobservable inputs or not based on market data	In inactive and less transparent market, orderly transaction

Fair value hierarchy



* Observable inputs include market data (prices and other information) that is publicly available

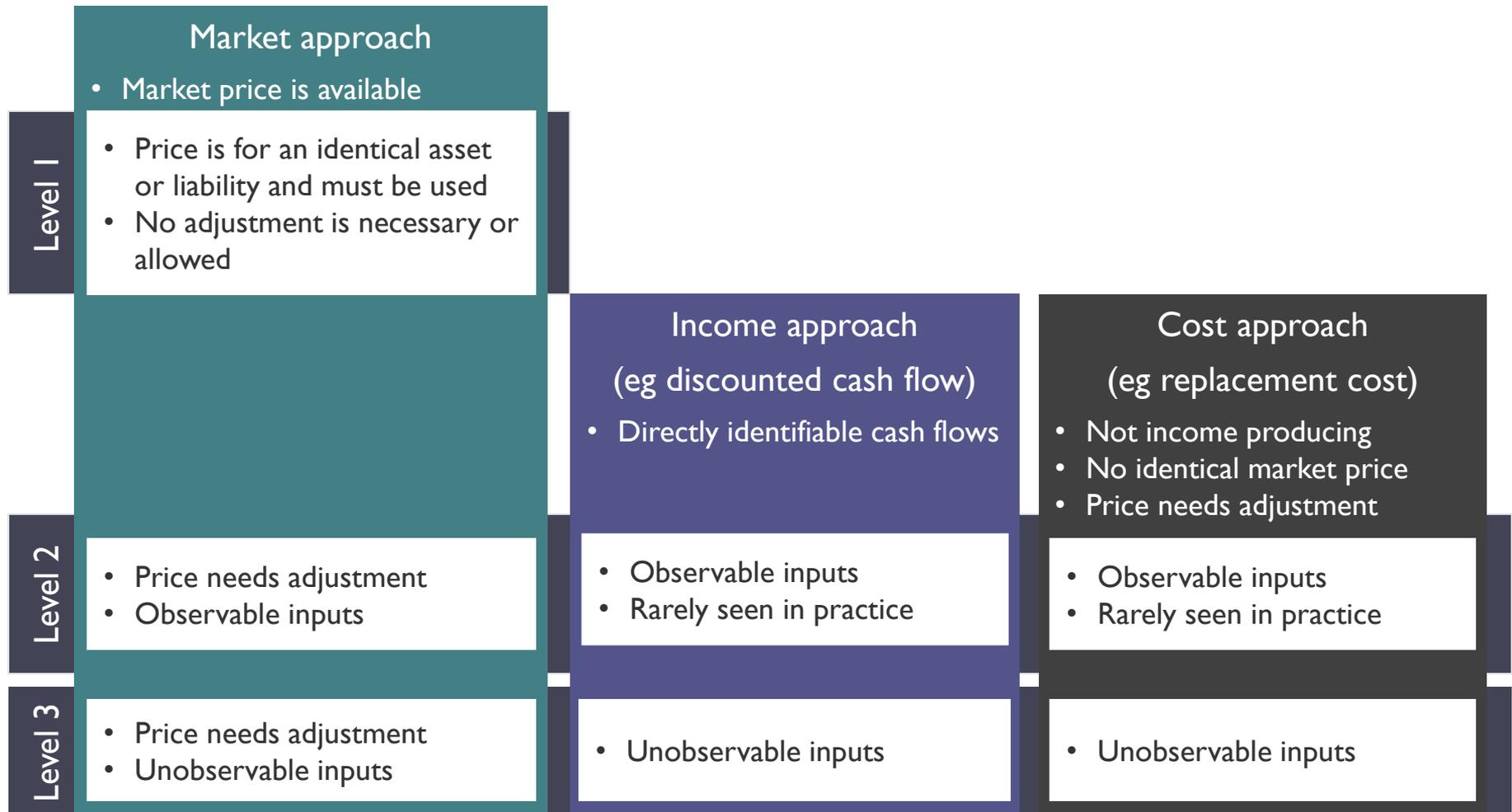
‡ Unobservable inputs include the entity's own data (eg budgets, forecasts)

FV Hierarchy & Valuation Method

Level 1	Quoted prices (unadjusted) in active market for identical assets and liabilities that the entity can access at the measurement date	Direct quotation, no valuation required
Level 2	Observable inputs other than quoted prices in level 1, either directly (ie, as prices) or indirectly (ie, derived from prices)	Direct Market Comparison, Income Approach, Cost Approach
Level 3	Unobservable inputs or not based on market data	Income Approach, Cost Approach (DRC Method)

Non Financial Assets will be falling under level 2 or level 3, depends on the quality of inputs

Selecting a valuation technique



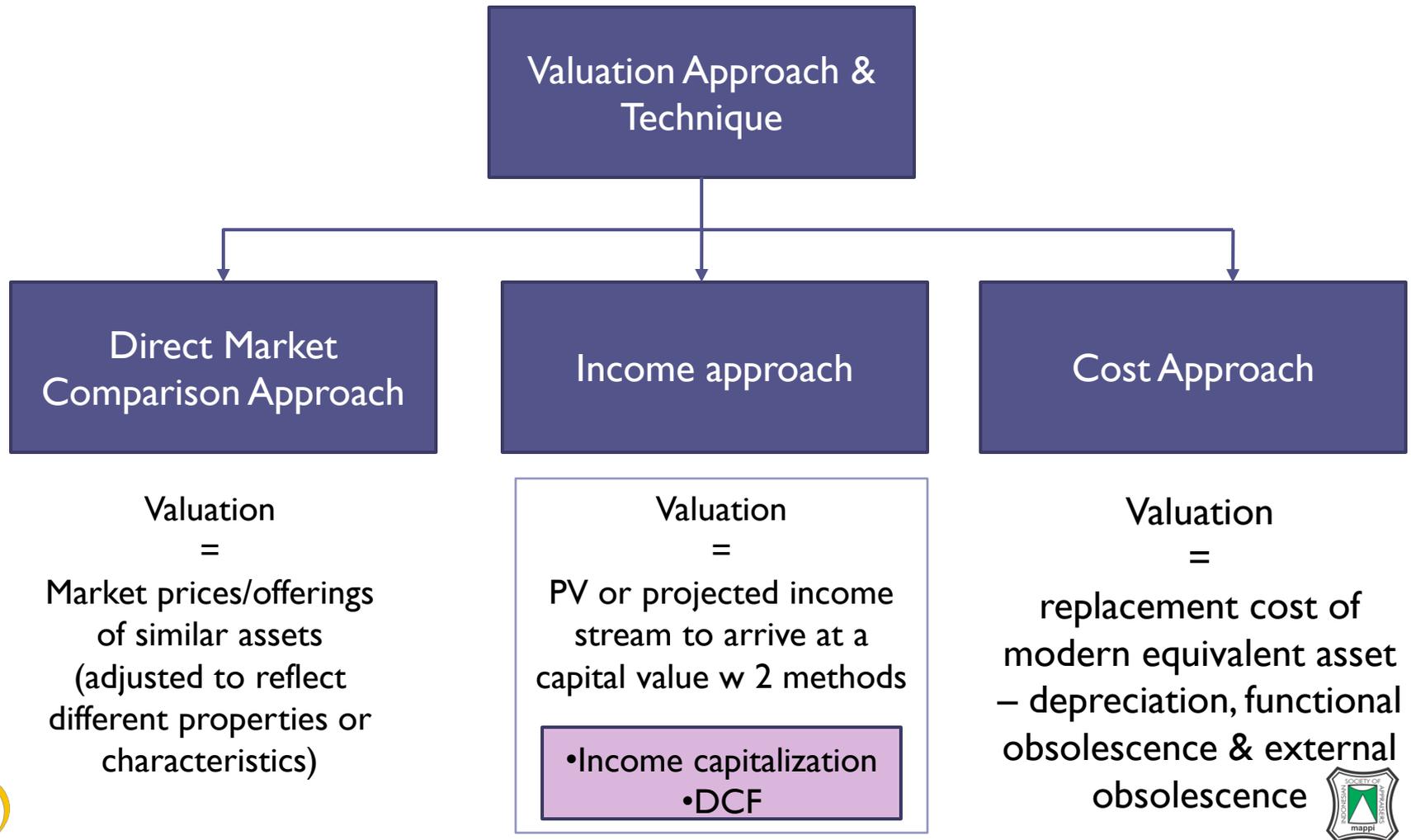
Is the market active?

- Indications a market is not active:
 - Few recent transactions
 - Price quotations not developed using current information
 - Wide bid-ask spreads or significant increases in spreads
 - Absence, or decline in, the market for new issues
 - Little public information

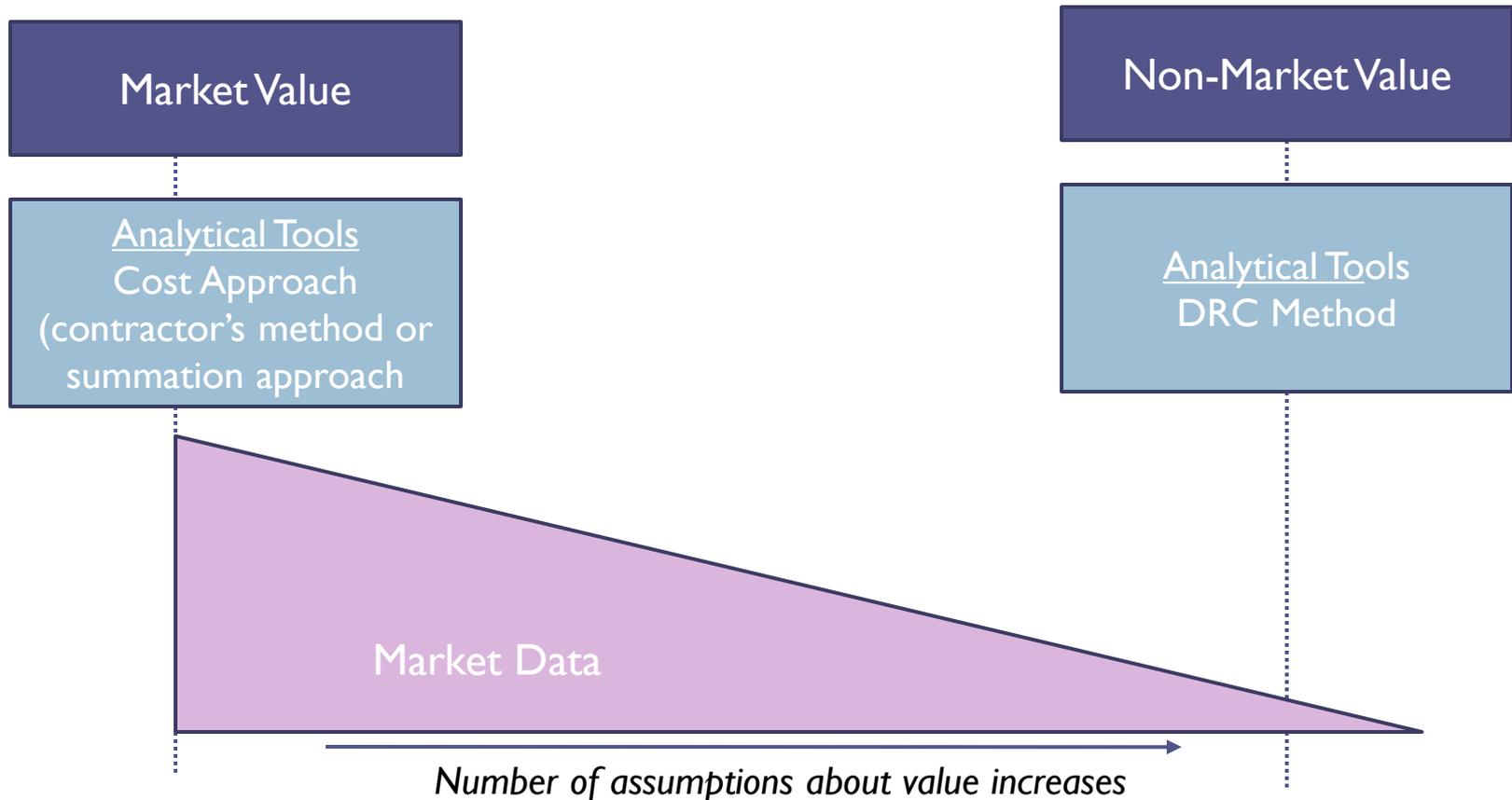
Are market transactions orderly?

- Indications a transaction is not orderly:
 - Inadequate exposure to market
 - Marketed to single market participant
 - Seller is distressed
 - Seller was forced
 - Transaction price is outlier

If no market price directly available, FV can be determined with valuation technique..



Continuum between MN and Non-MV and Available Analytical Tools

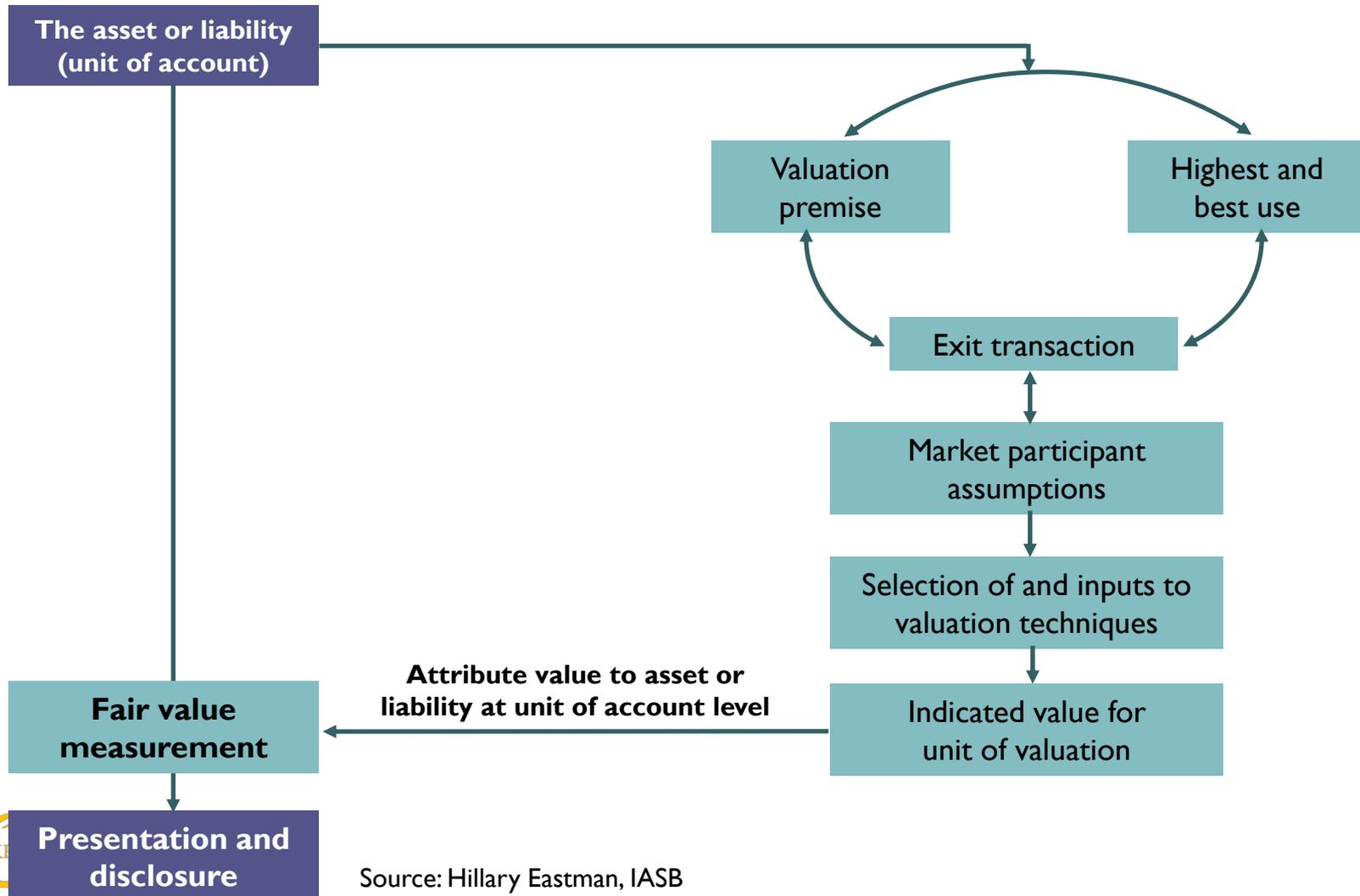


Property Categories
Non-Specialised properties

Property Categories
Limited Market &
Specialised properties



Summary: The measurement model



Source: Hillary Eastman, IASB



HBU for non-financial assets

- The market value of an asset will reflect its highest and best use (HBU). The HBU is the use of an asset that maximises its productivity and that is physically possible, legally permissible and financially feasible. The HBU maybe for continuation of an asset's existing use or for some alternative use.

HBU as a stand alone
asset

VS

HBU asset in
combination with other
assets or with other
asset and liabilities

Related IFRS & PSAK

- IAS 2 : Inventories
- IAS 16 : Property, Plant and Equipment → PSAK 16 : Aktiva Tetap
- IAS 17 : Leases
- IAS 28 : Investment in Associates
- IAS 36 : Impairment Assets
- IAS 37 : Provision, Contingent Liabilities and Contingent Assets
- IAS 38 : Intangible Assets → PSAK 19 : Aset tak berwujud
- IAS 39 : Financial Instrument : Recognition and Measurement → PSAK 50 : Instrumen Keuangan
- IAS 40 : Investment Assets → PSAK 40 : Properti Investasi
- IAS 41 : Agriculture
- IFRS 1 : First-time Adoption of IFRS
- IFRS 2 : Shared-based Payment
- IFRS 3 : Business Combinations → PSAK 22 : Kombinasi Bisnis
- IFRS 5 : Non-current Assets Held for Sale and Discontinued Operations
- IFRS 9 : Financial Instrument → PSAK 55 : Instrumen Keuangan

Requirements on when fair value is implemented

- Property, plant and equipment (IAS 16)
 - Initial measurement – cost
 - Subsequent measurement - choice of a “cost model” (cost less depreciation and impairments) or a “revaluation model” (fair value with certain adjustments)
- Intangible assets (IAS 38)
 - Initial measurement – cost
 - Subsequent measurement - choice of a “cost model” (cost less amortization and impairments) or a “revaluation model” (fair value) if an active market exists

Requirements on when fair value is implemented (cont'd)

- Investment property (IAS 40)
 - Property held to earn rentals or for capital appreciation or both
 - Initial measurement – cost
 - Subsequent measurement - choice of a “cost model” (cost less depreciation and impairments) or a “fair value” model
- Agriculture (IAS 41)
 - Includes biological assets (e.g., vines), agricultural produce (e.g., grapes) and products that are the result of processing after harvest (e.g., wine)
 - Initial and subsequent measurement – fair value less costs to sell, unless fair value cannot be measured reliably
- Impairment of assets (including goodwill) (IAS 36)
 - Compare recoverable amount to the carrying amount of the asset (step test)
 - Recoverable amount is the higher of fair value less costs to sell or “value in use” (similar to the US concept of “entity specific” value)

IVS & SPI

IVS 300 – Valuation for Financial Reporting

- Standard
 - Scope of work (IVS 101)
 - Implementation (IVS 102)
 - Reporting (IVS 103)
- Application Guidance
 - Fair Value
 - Aggregation – unit of account
 - Valuation inputs and Fair Value Hierarchy
 - Liabilities
 - Depreciation
 - Leases and Lease Classification
 - PPA
 - Impairment Testing

SPI – PPI I Penilaian untuk Tujuan Pelaporan Keuangan

- Basis of Value
 - MV
 - MV in existing use
 - Value in use
- Fair Value Measurement related with:
 - IAS 16 : PPE
 - IAS 40 : Investment Property
 - IAS 17 : Lease
 - IAS 36 : Impairment
 - IAS 2 : Inventory
 - IFRS 3 : Business Combination
 - IFRS 5 : Non Current Assets



What does this mean to the valuation profession?

- As it was when valuation professional is needed to “learn” PSAK, we will now be required to “learn” IFRS
- Until the adoption of IFRS 13, valuation professionals still need to be “bilingual” with respect to fair value measurement
 - ✓ Potentially greater focus on “entry price” and entity-specific assumptions under PSAK compared to the “exit price” notion under IFRS
 - ✓ Highest and best use
 - ✓ Principal market or most advantageous market under IFRS
 - ✓ Valuation of financial instruments with bid-ask spreads
- Valuation specialists will need to “go global” in terms of valuation purposes, resources, standards and data-gathering

What does this mean to the valuation profession? (cont'd)

- Valuation standard setting (IVS/SPI) and best practices will need to keep pace with accounting standard setting
 - ✓ Valuation professionals will need to stay abreast of changes
- Companies (i.e., financial statement preparers) will need help in the areas of accounting, valuation, IT systems, etc.
- Continuous learning

Issue 1: Market Information

- Background: Valuers in emerging market may find that reliable transactional and other relevant market data are insufficient either because publication of such data is not yet the established norm or people are more conservative about publicly disclosing such information
- Problem: How to define market-based valuation?
- Recommendation: Depending on the type of assets, valuer can use Income Approach for income producing assets or Cost Approach for non-income producing assets and specialized assets using observable market data (level 2). However, if an adjustment to level 2 input is significant to the entire measurement, the FV valuation will fall to level 3.

Issue 2 – Market Information (2)

- Background: In some situations, active property markets may provide Valuers with sufficient transactional and other relevant data to estimate MV, but there are situations that market information may not be easy to obtain
- Recommendation:
 - Due to the limited market, valuer may need to expend greater efforts in studying the market circumstances that have impacted the transactional data selected for use as comparable data. Suitable adjustments to the data should be supported by logical and consistent analysis. An unreasonable size or number of adjustments should preclude the use of such data as comparable data.
 - When market information is very limited and only part of the valuation can be supported by market evidence, Valuer must disclose this limitation to the user of the valuation and identify any part there of based on data other than that obtainable in the market. Any assumptions made in the calculation must also be disclosed and the potential impact on the value reported should be specified.

Issue 3 - Greater Market Volatility

- Background: In emerging markets, both internal factors such as asymmetric market information and external factors such as susceptibility to sudden capital flows may lead to economic volatility.
- Problem: How to define reliable MV in a volatile market?
- Recommendation: FV is measured on the date of valuation (measurement date) which is time specific as of given date. Because market and market conditions may change, the estimated value maybe incorrect or inappropriate at another time. The valuation amount will reflect the actual market state and circumstances as of the effective valuation date. If there are subsequent events occurred between date of valuation and date of report that affect value, valuer must disclose the nature and its effect in the report but should not alter the value.

Issue 4 – Growing importance of intangible property

- Background: In emerging economies, many intangible property rights were not fully recognized which are now in transition to becoming market economies, and intangible property rights have assumed special importance as a recognized category of property
- Problem: How to define that intangible property is in existence? And if any, how to measure?
- Recommendation: there should be a better coordination between auditor and valuer to work closely in conducting the assignment (usually related with PPA) and there should be a well-established guideline from SEC which conformed with the requirements in the IFRS and PSAK.

Issue 5 – DRC method

- Background: In emerging markets where transactional data is scarce and information on construction costs is more readily available, Depreciated Replacement Cost (DRC) methodology in valuation which may not be fully supported by market data is considered an acceptable methodology to arrive at a surrogate for the MV of specialized property or property with a limited market.
- Problem: Is DRC method acceptable in FV for financial reporting?
- Recommendation:
DRC is particularly helpful method in this situation, however, careful consideration has to be given to the principle of consistent use, especially where the information available is a combination of market and non-market data. Valuer must clearly identify the limitations of an estimate derived from DRC methodology.

Issue 6 – Investment Property

- Background: IAS 41 required investment property to be measured using FV model or cost model.
- Problem: How to determine the FV of investment property?
- Recommendation: Investment Property is defined in the standard as property held by the owner to earn rentals or for capital appreciation, therefore it can be classified as income producing property. Based on this nature, investment property should be valued based on Income Approach using observable market inputs (level 2).

Issue 7 – Biological Asset

- Background: IAS 41 required biological asset to be measured on initial recognition and at the end of each reporting period at its FV less cost to sell, except for the case where the FV can not be measured reliably.
- Problem: How to determine the FV of biological assets?
- Recommendation: In Indonesia, valuation of biological assets has been addressed in the valuation standard for agricultural properties. Basically, it is divided into producing and non-producing plants, where producing plants is valued by Income Approach (DCF model for 1-cycle planting period) and non-producing plants is valued by Cost Approach. Both approaches will utilize observable market inputs and the DCF model is considered a complex model which requires professional judgement in defining the price and production in in the projection.

Suggested Road Map to FVM

1. Improvement in valuation standards (SPI)
 2. Accountability and funding of the valuation standards setter
 3. Improvement in the infrastructure which enable valuers to use transparent market data
 4. Education and training
 5. Implementation of the mandatory use of the new SPI
- ✓ *Combines “convergence” (a country gradually moving local standards toward IVS) and “endorsement” (a country incorporating individual IVS into local standards)*

Terima Kasih

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