MEMORANDUM

DATE	:	**March 12, 2012**
TO	:	**Mr. James "J" R. Hambric and Dr. Etty Retno Wulandari**
FROM	:	**Mark F. Bates, MAI, CRE, FRICS**
CC	:	
SUBJECT	:	**International Accounting Standards, Fair Value, and Guidance for Regulators, Appraisers and Management in Indonesia**

Introduction

In May, 2011, the International Accounting Standards Board (IASB) issued International Financial Reporting Standard 13 (IFRS 13) to provide guidance on how to measure Fair Value when required under IFRS. As Indonesia moves toward full adaptation of IFRS, Indonesian appraisers will play a vital role in providing valuation services to help insure the safety and soundness of the Capital Markets. Appraisers will need to understand the professional duties that business entities, auditors and regulators will come to rely on as demand for IFRS 13 valuation services increase. BAPEPAM-LK will also play a significant role in the process through the issuance of appraiser licenses and appraisal regulations providing guidance and enforcement in the implementation of IFRS 13.

This white paper focuses only on IFRS 13 as it relates to real estate and does not address how or when it may be imposed as stipulated throughout IFRS in its entirety. IFRS 13 predominantly brings into a single standard the fair value concepts that were in other standards, but it also clarifies various requirements with regard to the appropriate measurement and disclosure of fair value and its underlying inputs.

The definition of fair value in IFRS 13 differs from that promulgated by International Valuation Standards (IVS) and Indonesia Assessment Standard SPI 2007 (SPI 2007). The fair value framework set out in IFRS 13 contains specific requirements relating to "highest

and best use", "valuation premise", and "principal market". This will require appraisers to revisit their appraisal procedures commonly utilized in ordinary practice governed by IVS and SPI 2007.

Appraisers must understand that the use of fee appraisers by a company's management does not reduce management's ultimate responsibility for the fair value measurements (and related disclosures) in the company's financial statements. Management is required to understand the methodologies and assumptions used in the valuations and determine whether the assumptions are reasonable and consistent with the requirements of IFRS 13. It is therefore incumbent on the appraiser to disclose and explain all inputs, adjustments, assumptions and limiting conditions of a fair value appraisal report written to conform with IFRS.

Definitions – Fair Value – IFRS 13 vs. IVS (2010) vs. SEPI (2007)

Although in many instances the measurement of fair value under IFRS 13 will be equivalent to fair value as defined by IVS and SEPI 2007, there are some subtle differences. The published definitions are shown below.

IFRS 13 defines the fair value of an asset as an 'exit price', hence *"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".*

IVS (2010) defines fair value as *"the estimated price for the transfer of an asset or liability between identified knowledgeable and willing parties that properly reflects the respective interests of those parties"*.

SEPI 2007 defines fair value as *"the exchange value of asset or the completion of obligations between the parties who understand and be willing to do fair trade"*. – Note: English Translation

The IFRS 13 definition adopts the concept of an exit price. Concerns about distinguishing between an entry price (purchase price) and an exit price (sales price) often relate to potential differences between an actual acquisition price (i.e. the price paid by a company to buy an asset, which is an entry price) and a hypothetical sales price (i.e. the price that would be received to sell that asset, which is an exit price). The IASB intent is to clarify that fair value is a market-based measurement, not a company-specific measurement, and that fair value reflects current market conditions. For example, even though a developer overpaid for

a lot of land because the purchase was to his specific advantage, the fair value of the land is not what he paid for it (entry price), but what he can sell it for (exit price).

From a real estate appraiser's perspective, in most cases there won't be an issue with the concept of exit price, as the exit price will often be equal or almost equal to the market value as defined in IVS and SEPI 2007. It is however important to keep in mind the estimation of fair value should always be based on a market participant's point of view.

Highest and Best Use Concept

According to IFRS 13, the fair value measurement of non-financial assets (including real estate) must reflect the highest and best use of the property from a market participant's perspective. The highest and best use of a property establishes the valuation premise used to measure the fair value of the property, i.e. whether to assume a market participant (buyer/owner) would derive value from using the property on its own or in combination with other assets. The highest and best use might be its current use or some alternative use. Appraisers are well versed in this concept of highest and best use however there are some subtleties that need to be explored in the determination of fair value.

Fair value measurements of real estate and other non-financial assets take into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant that would use the asset in its highest and best use.

Highest and best use refers to "the use of a non-financial asset by market participants that would maximize the value of the asset or the group of assets and liabilities (i.e. a business) within which the asset would be used". Real estate appraisers don't normally consider whether the highest and best use of a property may be in a combined use with other assets. This is an important distinction between what is normal practice for real estate appraisers and what is required under IFRS 13.

The highest and best use of an asset considers uses of the asset that are:

a. Physically possible: the physical characteristics of the asset that market participants would take into account when pricing the asset (i.e. the shape, size, impairments and location of a property).

b. Legally permissible: any legal restrictions on the use of the asset that market participants would take into account when pricing the asset (i.e. the zoning and other regulations and restrictions applicable to a property). A use of an asset need not be legal at the effective date of the appraisal, but it must not be legally prohibited. Considerable judgment may have to be applied in determining when an anticipated change is legally permissible. For example, if approval is required for rezoning land, it may be necessary to determine whether such approval is reasonable or not. Appraisers should explain the evidence to support their view on market participants' assumptions about the ability to obtain any required approvals.

c. Financially feasible: whether a use of the asset that is physically possible and legally permissible, and in the case of investment real estate, generates adequate income or cash flows (taking into account any costs of converting the property to that use) to produce an investment return that market participants would require from an investment in that property put to that use.

IFRS 13 presumes that an owner's current use of a property is its highest and best use, unless market or other factors suggest that a different use of the property by market participants would maximize the value of the property. Because the highest and best use of a property is to be determined based on market participants' expectations, appraisers should consider alternative uses of a property in their analysis of fair value. However, the consideration of alternative uses is not intended to be an exhaustive exercise and it is not necessary that all possible alternatives be considered. Instead, judgment is required in assessing those alternative uses that market participants would consider in pricing the property. As noted above, consideration of what is physically possible, legally permissible and financially feasible would be part of this assessment.

If an owner or appraiser determines that the highest and best use of a property is different from its current use, IFRS 13 requires this to be disclosed as well as the reason why the property is being used in a manner that differs from its highest and best use.

Example (Based on IFRS 13 Example)

Highest and best use vs. current use Assume an entity acquires real estate in a business combination. The land is currently developed for industrial use as a site for a factory. The current use of the property is presumed to be its highest and best use unless market or other factors suggest a different use. Nearby sites have recently been developed for residential use as sites for high-rise apartment buildings. On the basis of recent developments and recent rezoning and other changes to facilitate high rise apartment development, the appraiser determines that the land currently used as a site for a factory could be developed as a site for residential use (i.e. for high-rise apartment buildings) because market participants would take into account the potential to develop the site for residential use.

The highest and best use of the property would be determined by comparing both of the following:

a. the value of the property as currently developed for industrial use (i.e. the property would be used in combination with other assets as part of a business).
b. the value of the land as a vacant site for residential use, taking into account the costs associated with demolishing the factory and other costs (including risk) necessary to convert the property to a vacant site for development.

The highest and best use of the property would be determined on the basis of the higher of those values.

Let's assume that the fair value of the factory as a manufacturing operation is determined to be 4,000,000,000 IDR and that the fair value for the land as a vacant site that can be used for residential purposes is 5,000,000,000 IDR. In order to convert the property from a manufacturing operation to a vacant site for residential use, the manufacturing facility must be removed. Assuming demolition and other costs of 500,000,000 IDR, the fair value of the land as a vacant lot for residential use would be 4,500,000,000 IDR. Therefore, the amount of 4,500,000,000 IDR must be used as the fair value of the property. This concept is similar to that employed by real estate appraisers in their normal course of business.

For simplicity purposes, this example does not address other types of costs that may be incurred in determining the fair value of the land for residential use (such as the effect of intangible or other assets related to the manufacturing facility, risk, etc.). To summarize, if the value of the land as vacant exceeds the value as currently improved, taking into account demolition costs, soft costs and risk, the highest and best use may be an alternative use.

Appraisers must also be aware that a company's intended use of an asset may not be the same as how market participants would use the asset. Where this occurs, it could result in differences between the entities transaction price (entry price) and fair value as measured in accordance with IFRS 13 (exit price), because IFRS 13 requires that the highest and best use of an asset be determined from the perspective of market participants, even if an owner intends a different use.

Example: Highest and best use vs. intended use (Based on IFRS 13 Example)

Assume a company acquires an unfinished research and development (R&D) facility in a business combination. The company does not intend to complete the facility. If completed, the facility would compete with one of its own facilities. Instead, the company intends to hold onto the facility to prevent its competitors from obtaining access to the technology. In doing this the facility is expected to provide defensive value, principally by improving the prospects for the company's own competing technology to succeed. To determine the fair value of the facility, the highest and best use of the facility would be determined on the basis of its use by market participants, not the company. For example, consider the following:

a. The highest and best use of the R&D facility would be to continue development if it is determined that market participants would continue to develop the facility and that use would maximize the value of the group of assets or of assets and liabilities (i.e. business). That would be the case if market participants do not have similar technology, either in development or operating. The fair value of the facility would be measured on the basis of the price that would be received in a current transaction to sell the facility, assuming that the R&D facility would be used with its complementary assets and the associated

liabilities and that those assets and liabilities would be available to market participants.

b. The highest and best use of the R&D facility would be to cease development if market participants would discontinue its development. That might be the case if the facility is not expected to provide a market rate of return if completed and would not otherwise provide defensive value if held. The fair value of the facility would be measured on the basis of the price that would be received from market participants in a current transaction to sell the facility on its own (which might be zero).

If the highest and best use in this example was (a), then that is the value that the company must ascribe to the R&D facility, even though its intended use is to stop development and hold the facility. The bottom line is that an appraiser, in determining highest and best use, must view a property from the perspective of market participants and not a specific entity's intended use.

It is noted that in most cases, assets in an asset group (including real estate) should all be valued using the same valuation premise. For example, if the fair value of a factory as part of a business is measured assuming its highest and best use is in conjunction with other property and equipment in the manufacturing process, those other assets in the asset group would also be valued on the same basis. Once it is determined that a set of assets would be sold as a group, all of the assets in that group would be valued under the same premise, regardless of whether any individual asset within the group would have a higher value under another premise.

Valuation Premise

The fair value of a real estate asset that has a highest and best use in combination with other assets (that is, in a group) is determined on the basis of the use of the asset together with those other complementary assets, even if the asset is aggregated or treated separately at a different level when applying other IFRS. In contrast, the fair value of a real estate asset that provides maximum value on a stand-alone basis is measured based on the price that would be received to sell that property interest on a stand-alone basis.

To illustrate the above, consider a mixed-use property that has residential housing, a hotel and retail space: If the aggregate fair value of the mixed-use property interest is higher to market participants than the sum of the fair value of the individual property interests because of synergies and complementary cash flows, the fair value of that mixed-use property interest would be maximized as a group.

While the mixed-use property interest is one example in which fair value would be maximized as a group, in many cases, it would not be appropriate to estimate fair value of property interests as a group. For example, property owners generally should not assume the fair value of a property interest is maximized through its use with other assets, unless there is sufficient evidence to support this assertion.

Determining whether the maximum value to market participants would be achieved either by using a real estate asset in combination with other real estate assets as a group, or by using the real-estate asset on a stand-alone basis requires considerable judgment of the specific facts and circumstances by the appraiser.

The challenge for the appraiser will be in assisting the client in defining the scope of the assignment relative to the valuation premise to ensure that the fair value produced by the appraiser is consistent with, and satisfy, the requirements of IFRS 13. The appraiser should be alert to the possibility that the scope of the assignment might require a team of valuation professionals, each providing distinct valuation expertise in such areas as real property, personal property, manufacturing processes, and intangible assets. Defining the group of assets involved in the assignment will be critical.

Fair Value Hierarchy

Since market-based assumptions form the primary input for valuation, and there are different observable and unobservable levels of markets, IASB has adopted a hierarchical structure. Under this hierarchy, an appraisal should be tied to the highest level possible under the circumstance.

- Level 1 relates to quoted prices for identical assets. Real estate rarely has an identical twin, so valuation normally requires reference to the next level.
- Level 2, which is based on observable values for similar transactions, such as comparable property transactions. Level 2 is quite logical for real estate.

- Level 3 drops to reliance on subjective and unobservable inputs, such as knowledge, judgment, and experience with the particular market. If Level 3 inputs are applied, sufficient support and discussion is required.

In market conditions where real estate is actively purchased and sold, the fair value measurement inputs might be classified in Level 2. However, that determination will depend on the facts and circumstances, including the significance of adjustments to the observable data. In this regard, IFRS 13 provides a real-estate specific example, stating that a Level 2 input would be the price per square meter for the property interest derived from observable market data, i.e. multiples derived from prices in observed transactions involving comparable (i.e., similar) property interests in similar locations. Accordingly, in active and transparent markets, real estate valuation inputs may be classified as Level 2, provided that no significant adjustments have been made to the observable data. If significant adjustments to observable data are required, the fair value measurement may fall into Level 3.

In inactive or less transparent real estate markets, it is generally unlikely that real estate inputs will be classified in Level 2, but, rather, will be classified as Level 3.

When selecting the most appropriate inputs to a fair value measurement from multiple available values, those that maximize the use of observable data, rather than unobservable data, should be selected. Even in a market that is inactive, there is not a presumption that all transactions in the market do not represent fair value or that the market is not orderly, just because that market is no longer active or the volume in that market has significantly decreased. Appraisers will need to consider the individual facts and circumstances in making this assessment.

Level 2 Input Examples

- Sale prices per sqm for similar properties in similar locations
- Observable market rent per sqm for similar properties
- Property yields derived from recent transactions

Level 3 Input Examples

- Yields based on the appraiser's projection
- Significant yield adjustments based on the appraisers assumptions about uncertainty/risk

- Assumptions about future market conditions (for example, vacancy, rent growth, expense growth, etc.) that are not derived directly from the market
- Cash flow assumptions not derived directly from the market

Three Approaches to Value

IFRS 13 does not favor a specific approach to value. Prior to adoption of IFRS 13, the fair value hierarchy in older IFRS guidance favored the application of the market approach over the income approach (discounted cash flows). However, the fair value hierarchy in IFRS 13 is based on valuation inputs by maximizing the use of relevant observable inputs (Level 1 and Level 2) and minimizing the use of unobservable inputs (Level 3) rather than the valuation techniques themselves.

According to IFRS 13, as in typical real estate appraisal practice, there are generally three approaches that can be used to derive fair value: the market approach, the income approach and the cost approach. To measure fair value, appraisers should use valuation techniques consistent with one or more of these approaches. They should use valuation techniques that are appropriate in the circumstances and for which sufficient data is available, maximizing the use of relevant observable inputs and minimizing the use of unobservable inputs. Valuation techniques should be applied consistently. However, a change in the approach or its application' may be appropriate if the result is 'equally or more representative of fair value.

As market participants would usually estimate the price of an investment property based on their expectations about future income projections, the income approach will often be the most reliable. Even though the application of a cost approach is permitted and possible due to the availability of sufficient data it would likely carry less weight. For specific use properties where there is limited income data and few sales, the cost approach may be the most applicable. For owner occupied properties where there is an active market, the market approach in the logical choice.

IFRS 13 encourages the application of multiple valuation techniques (market approach, income approach and cost approach), if appropriate. If multiple approaches are applied, the respective indications of fair value should be reconciled based on the reasonableness of the range of values indicated by those results and the strength of the data.

Disclosure Requirements

IFRS 13 calls for enhanced disclosure requirements in order to provide users of financial statements with more reliable information about the uncertainty inherent in fair value measurements and to strengthen confidence in fair value measurements.

The most important disclosure requirements for non-financial assets (real estate) under IFRS 13 are shown below.

Level 2

- Description of the valuation technique(s) and the inputs used in the fair value measurement
- Any changes in valuation techniques and reasons for making those changes

Level 3

- Description of the valuation technique(s) and the inputs used in the fair value measurement
- Any changes in valuation techniques and reasons for making those changes
- Support and quantitative information about any significant unobservable inputs used in the fair value measurement if reasonably available
- Full description of the valuation process.
- If the highest and best use differs from its current use, an explanation should disclose the fact and why the asset is being used in a manner that differs from its highest and best use
- Narrative description of sensitivity of the fair value measurement to significant changes in unobservable inputs

Challenges for the Appraiser

Appraisers engaged to provide appraisals that conform to IFRS 13 need to have a clear understanding of the subtleties inherent in the regulation. The Standard has some principles and requirements that may be less familiar, or not intuitive, to the professional appraiser.

These include requirements that are primarily accounting concepts rather than valuation issues.

It is incumbent on appraisers to determine if their professional credentials and competency are appropriate for the intended use of the appraisal. The appraiser must realize that audited financial statements are typically intended for financial reporting, and as such will be subject to the extensive rules and scrutiny of financial reporting requirements.

The appraiser must clearly indicate that the purpose of the appraisal is to develop an opinion of fair value for use in financial reporting and then needs to state the specific definition of fair value used in the appraisal. The appraiser must understand that the scope of the work performed and the work product must be sufficient to meet the requirements of the financial accounting standards for which the appraisal work is being performed.

The auditor is required to obtain an understanding of the nature of the work performed by an appraiser (specialist). This understanding should cover the objectives and scope of the appraiser's work, the appraiser's relationship to the client, the methods or assumptions used, a comparison of the methods or assumptions used with those used in the preceding period if applicable, and the appropriateness of using the appraiser's work for the intended purpose.

In most cases, the appraiser's analysis will be provided in the appraisal report. It most certainly should be maintained as part of the appraiser's work papers in the event the auditor or regulator needs to make additional inquiries to satisfy their requirements.

During initial discussions, the appraiser and client will need to address the purpose and scope of the fair value assignment, the intended use of the appraisal, and the impact of IFRS reporting requirements on the final work product.

All assumptions, extraordinary assumptions, hypothetical conditions, and limiting conditions used in the assignment must be clearly and accurately disclosed. The appraiser needs to determine that the use of hypothetical or limiting conditions and/or any assumptions are not inconsistent with the financial reporting standards.

Although many concepts of IFRS 13 may be similar to SPI 2007, company auditors and management will likely perform a review of appraisals performed for valuation reporting to assure that the appraised value is an appropriate measure of fair value.

Such a review would include, but is not limited to, determining whether:

- The principal or most advantageous market has been appropriately considered
- Appropriate market participants (or characteristics of market participants) have been identified and the assumptions that market participants would utilize in pricing the property have been applied.
- Adjustments to valuation input data are (a) based on observable or unobservable inputs, and/or (b) significant to the overall fair value appraisal. Inputs are adequately explained and analyzed.
- All appropriate valuation approaches and techniques have been used and if multiple valuation techniques are used, the merits of each approach and the underlying assumptions utilized in each approach should be considered in evaluating and assessing the results.
- Appropriate judgment has been applied in assessing the highest and best use.

Conclusion

While many of the concepts in IFRS 13 are consistent with current appraisal practice, certain principles and disclosure requirements could have a significant impact on an appraiser's Scope of Work and final work product.

In many cases, the concepts of highest and best use and the valuation premise may not be significantly different from traditional practice; nevertheless, careful consideration is required to identify those situations in which there is a significant difference. Be aware that there are still differences in fair value concepts between IFRS and SPI 2007. For example, SPI 2007 does not recognize a fair value hierarchy and SPI 2007 applies a different fair value definition. Reviewers, auditors and company management bound by IFRS should be aware of these differences when reviewing appraisals prepared pursuant to SPI 2007.

As IFRS 13 is applied going forward, appraisers, management and auditors will become familiar with the IFRS 13 and will face new questions, especially when presented with scenarios to be considered in future valuations. Ultimate guidance will evolve as clients, auditors and reviewers provide commentary on fair value appraisals performed under IFRS 13 going forward.

In order to effectively manage the transition to IFRS, it is important for regulators and BAPEPAM approved appraisers to have a clear understanding of the definition of Fair Value

under IFRS 13 and how it differs from traditional market value. This will help to smooth the transition to IFRS by putting appraisers and regulators on the same page going forward.

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