Thematic Review:

IFRS 13 ‘Fair value measurement’

Financial Reporting Council

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Contents

1. Executive summary

Introduction

IFRS 13 'Fair Value Measurement', has featured in the Corporate Reporting Review (CRR) team's Top Ten matters of challenge several times in the past. While the application of IFRS 13 is, based on our work, generally satisfactorily applied by larger companies and its principles are well understood by certain sectors such as banking, insurance and real estate, smaller companies can struggle with the requirements.

The current market environment is challenging for many businesses, with high inflation and rises in interest rates in many leading economies. Consumer behaviour continues to evolve in response to the cost-of-living crisis, which may, for some industries, mean significant changes in profits and cash flow forecasts. The effects of climate change may become more pronounced in forward-looking assumptions and fair values of some assets. The degree of estimation uncertainty and management judgement required in fair value measurements may also increase. All these factors may significantly impact financial position and/or performance. Consequently, clear and transparent disclosures, about the uncertainties, risks and significant assumptions underlying fair value measurements reported in the financial statements, are likely to become increasingly important.

This publication is not intended to be a guide to valuations. It reflects CRR's experiences with IFRS 13 and has a particular focus on disclosure matters, although some measurement issues are also discussed.

1. Executive summary (continued)

Summary of key findings

Fair value measurements should use market participants' assumptions

- Fair value measurements should use market participants' rather than the company's own assumptions.
- Whilst the transaction price usually reflects fair value, there may be circumstances where this is not the case, for example, in transactions with related parties. Companies should ensure that appropriate adjustments are made to fair value measurements in such cases.

Companies should consider the need for specialist third party advice

- Where a company is required to value a material item, and where no internal expertise exists, we expect companies to consider whether specialist third party input is required. Where such advice has been obtained, we encourage companies to disclose that fact.

High quality disclosures are key

- IFRS 13 disclosures should be provided for each class of assets and liabilities, determined on the basis of their nature (for example, debt vs equity investments), characteristics and risks (including climate change). When determining an appropriate level of aggregation or disaggregation, companies should consider which provides the most useful disclosures.
- We find most issues in the disclosure of recurring Level 3 measurements, for which the significant unobservable inputs should be quantified and a sensitivity analysis given. However, these disclosures are sometimes omitted. Companies should ensure that the minimum disclosures required by the standard are provided.
- Companies should address the overall disclosure objective of the standard, not only the specific requirements. For example, the following additional information may be relevant to users: the nature of the item being measured at fair value and the characteristics of the item that are considered in the determination of the relevant inputs.
- Companies should avoid boilerplate and immaterial information.
- Where climate-related matters materially affect fair value measurement, we expect companies to explain how the impact has been incorporated into the measurement and, if relevant, to quantify any significant estimation uncertainty. Simply stating that the risk has been incorporated into the fair value measurement is insufficient in such cases.
- Information on fair value measurements should be consistent across the annual report and accounts. Management commentary should complement and further explain fair value measurements as this will enhance users' understanding.

2. Scope and how to use this publication

Scope

This thematic considers the requirements of IFRS 13, with a particular focus on disclosures, reflecting the fact that most of our IFRS 13 challenges are prompted by poor disclosure. However, we address those aspects of measurements where we have found errors.

We have not considered the application of IFRS 13 by banks and insurers because they typically have specialised teams that perform the valuations and the quality of their reporting in this area is usually high.

We did not select a sample of annual reports and accounts to review for this thematic. Instead we identified, through our routine work and by working with other FRC departments, examples of better disclosure and opportunities for improvement.

Using this publication

This thematic summarises briefly the financial reporting requirements on fair value measurements and related disclosures. It is not intended to cover all aspects of the relevant requirements and should not be relied upon as a guide to the detailed requirements.

The examples presented in this report will not be relevant for all companies or all circumstances, but each demonstrates a particular characteristic of a better disclosure. Inclusion of an extract from a company's annual report and accounts (ARA) should not be seen as an evaluation of that company's overall compliance with the reporting requirements of IFRS 13 or its reporting as a whole and should not be relied upon as such.

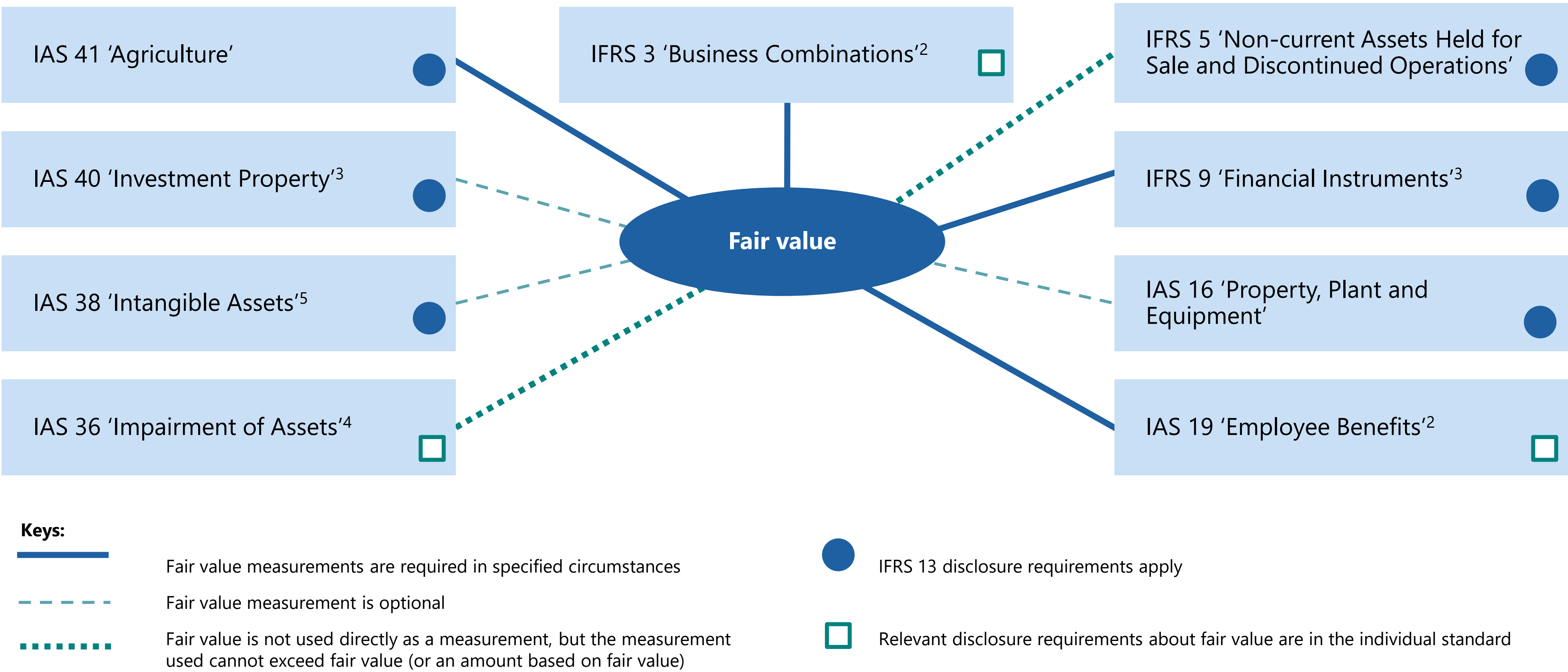
As explained on page 9 of our 'What makes a good annual report and accounts', companies should apply the concept of materiality to relevant information in order to determine what should be disclosed, ensuring that key information is not lost in distracting detail.

We used symbols in this report to denote:

- A good quality application that we want other companies to consider when preparing their annual reports.
- Opportunities for improvement by companies to move them towards good practice.
- An omission of required disclosure or other issue. We want companies to avoid such issues in their annual reports.
- A case study which illustrates improvements to reporting and disclosures as a result of engagement with companies as part of our routine reviews.

3. Fair value measurements

Different IFRSs require or permit companies to measure or disclose the fair value of assets, liabilities or own equity instruments. IFRS 13 provides a framework for measuring fair value and enhances the disclosures about fair value measurements. This diagram summarises uses of fair value measurements determined by individual standards, and when IFRS 13 disclosure requirements apply.[1]



1 This is a graphic representation of the summary included on page 20 of IFRS Foundation report 'Post-implementation Review of IFRS 13'
2 These IFRS standards have bespoke disclosure requirements for assets/liabilities that they require to be measured at fair value
3 Fair value measurement disclosures are required even when the measurement basis is amortised cost (IFRS 9) or cost (IAS 40)
4 IAS 36 has bespoke disclosure requirements for recoverable amounts determined as fair value less costs of disposal
5 For intangible assets to be carried at fair value, IAS 38 requires that their fair value is determined by reference to an active market. Paragraph 78 of IAS 38 states that it is uncommon for an active market to exist for an intangible asset

3. Fair value measurements (continued)

Fair value at initial recognition

The objective of fair value measurement 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. In many cases, the transaction price will equal the fair value. However, differences may exist in certain circumstances, for example, in transactions between related parties where an off market element may represent a capital contribution or a deemed distribution. Paragraph B4 of IFRS 13 provides more examples of situations where differences may occur.

We expect companies to assess whether the terms of related party transactions are at market rates, taking into account a market participant's assumptions about the associated risk, (please see page 13) and appropriately reflect these considerations in fair value measurements at initial recognition.

Case study: related party transactions at initial recognition

Background
The company provided long-term loans to a joint venture at a low interest rate and guaranteed its external debt.

FRC's approach and the company's response
We asked the company to explain whether the fair valuation of the loans receivable reflected the assumptions that market participants would use in pricing a similar asset on initial recognition. In response to our enquiry, the company confirmed that the interest rate on the loans was below a market rate. Therefore, the transaction prices of these assets at initial recognition did not reflect fair value.

We also queried the accounting for the guarantees. The company determined that the guarantees issued to the external lenders of the joint venture met the definition of financial guarantee contracts within the meaning of IFRS 9. These guarantees had been provided for nil consideration, which did not reflect their fair value as a market participant would have required compensation for providing them.

The company established fair value of the receivable assets and financial guarantee liabilities at initial recognition and, as a result, restated the accounts to reduce the receivable assets, recognise the liability in respect of the financial guarantee contracts and increase its investment in the joint venture by the corresponding amount.

3. Fair value measurements (continued)

Specific measurement considerations

IFRS 13 does not prescribe a particular valuation technique, but instead requires that the valuation maximises the use of relevant **observable** inputs and minimises the use of **unobservable** inputs. Below we consider areas where specific measurement challenges may exist.

Possible challenges in valuing unquoted equity investments

IFRS 9 requires companies to measure **all** investments in equity instruments at fair value, even if those instruments are not quoted in an active market.

Measuring the fair value of unquoted investments, which are particularly prevalent in private equity, can be challenging due to the lack of market data and other key information necessary to perform fair value measurements and may require judgement in relation to:

- the most appropriate valuation technique, which will depend on the particular characteristics of the instruments and the information that is reasonably available to the investor at the measurement date; and
- the extent to which any valuation adjustments (for example, a discount for the lack of liquidity) are required.

The company explains the reason for applying different methodologies for different investments. It also quantifies the investments to which a specific methodology has been applied on the same page.

Private Equity unquoted valuation

To arrive at the fair value of the Group's unquoted Private Equity investments, we first estimate the entire value of the company we have invested in – the enterprise value. We then apportion that enterprise value between 3i, other shareholders and lenders ...

[Earnings methodology] ... Used for investments which are typically profitable and for which we can determine a set of listed companies and precedent transactions, where relevant, with similar characteristics.

[Discounted cash flow] ... Appropriate for businesses with long-term stable cash flows, typically in Infrastructure or alternatively businesses where the DCF is more appropriate in the short term ...

3i Group plc, Annual report and accounts 2022, p171

The company also explains on the same page how the inputs into valuation techniques are selected and the valuation adjustments required.

3. Fair value measurements (continued)

In determining an appropriate indicator of fair value of a private equity investment and depending on the availability of comparable data, companies may decide to refer to recent transactions for identical instruments or to prices paid for similar, but not identical instruments. Additional considerations, set out below, would apply.

Cost paid in a recent transaction for an identical unquoted investment

Cost may be an approximate estimate of fair value subsequent to initial recognition in only limited circumstances. For example, it may be appropriate 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.

Companies need to assess whether the amount paid in a recent transaction (including the price paid by other investors) is representative of fair value at the measurement date. For example, if changes in market conditions affect the investee's growth prospects or the achievement of milestones, it will be necessary to assess the impact of those changes and adjust the cost accordingly.

Paragraph B5.2.4 of IFRS 9 includes examples of factors which may indicate that the cost of a financial instrument might not be representative of fair value.

Price paid for a similar, but not identical instrument

Where a company intends to value an investment using the transaction price for a similar, but not identical instrument, it should understand any differences between the instruments. Such differences may include different economic and control rights, which may require adjustment in fair value measurement.

Other adjustments

Depending on facts and circumstances, a number of different valuation adjustments may be required, including, for example, a non-controlling interest discount[6] and a discount for the lack of liquidity.

Companies should explain the basis on which the valuation has been carried out and any significant judgements and adjustments they have made.

The IFRS Foundation's Educational Material 'Measuring the fair value of unquoted equity instruments within the scope of IFRS 9' may be helpful for companies in such fair value measurements.

The guidance includes a number of examples illustrating particular aspects of different valuation approaches and sets out common tripwires in applying commonly used valuation techniques (paragraph 130).

6 Paragraphs 59 to 67 of the IASB's Educational Material 'Measuring the fair value of unquoted equity instruments within the scope of IFRS 9' explain when such discounts may be appropriate

3. Fair value measurements (continued)

Business combinations

Measuring assets and liabilities acquired

Companies should apply the specific measurement requirements of IFRS 3 to assets and liabilities acquired in a business combination and incorporate market participants', rather than their own, assumptions, where appropriate.

Case study: right-of-use (ROU) asset acquired in a business combination

Background
In our routine casework we identified that a company adjusted the ROU asset to reflect company specific circumstances rather than differences between the lease terms and market terms.

FRC approach and company's response
Following our enquiries, the company remeasured the ROU asset and restated the comparative amounts in the following year's annual report and accounts, with consequential amendments to goodwill, deferred tax, impairment and depreciation.

Consideration transferred, including contingent consideration

The consideration transferred in a business combination comprises the sum of the **acquisition-date** fair values of the assets transferred, liabilities incurred and the equity instruments issued by the acquirer.

Many business combination transactions include contingent consideration arrangements, where the acquirer transfers additional consideration to the former owners after the acquisition date if specified events occur or conditions are met in the future.[6] Such consideration can be in the form of cash or shares, or other assets. As explained on page 24 of our thematic report on business combinations, except for the measurement period adjustments and contingent consideration recognised as equity, which is not remeasured, post acquisition contingent consideration is carried at fair value through profit and loss.

IFRS 3 requires disclosure of information about the contingent consideration arrangements arising on business combinations, the valuation techniques and key model inputs used to measure contingent consideration, an estimate of the range of outcomes and the subsequent changes in those ranges.

In addition, IFRS 13 disclosure requirements apply to recurring fair value measurements, such as contingent consideration, which typically use significant unobservable inputs and represent Level 3 measurements. Consequently, the disclosure requirements for recurring fair value measurements of financial instruments of IFRS 13 would apply, including **quantification** of significant unobservable inputs and **quantitative** disclosure of sensitivity (please see page 20). This requirement is often overlooked.

6 IFRS 3 distinguishes between contingent consideration and employee remuneration, which is addressed in our thematic on business combinations

3. Fair value measurements (continued)

Fair valuation of non-financial assets

Highest and best use valuation premise

For non-financial assets, the fair value measurement takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use even if it differs from the company's current use. For example, to protect its competitive position, a company may decide not to use an acquired intangible asset actively, but to use it defensively by preventing others from using it.

If the highest and best use of a non-financial asset measured at fair value differs from its current use, that fact should be disclosed as well as the reason for using the asset in a manner other than highest and best use.

In some cases, the highest and best use for the asset would be in combination with other assets and liabilities (for example in a business). In such cases we would expect companies to explain how the fair value determined for the group has been allocated to individual assets.

The company explains how it applied the 'highest and best use' valuation premise in the fair value measurement.

The company, a provider of flexible office space, discloses the fact and the reasons for using specific assets in a manner that differs from their highest and best use.

For properties undergoing refurbishment … , most of these are currently being used for business accommodation … However, the valuation is based on the current valuation at the balance sheet date including the impact of the potential refurbishment … as this represents the highest and best use …

… When valuing properties being refurbished … the residual value method is used. The completed value of the refurbishment is determined as for like-for-like properties above. Capital expenditure required to complete the building is then deducted and a discount factor is applied to reflect the time period to complete construction and allowance made for construction and market risk to arrive at the residual value of the property.

The discount factor used is the property yield that is also applied to the estimated rental value to determine the value of the completed building. Other risks such as unexpected time delays relating to planned capital expenditure are assessed on a project-by-project basis, looking at market comparable data where possible and the complexity of the proposed scheme.

Workspace Group PLC, Annual Report and Accounts 2022, p216

3. **Fair value measurements** (continued)

Fair valuation of biological and specialised assets

For biological or specialised assets we expect companies to explain how they incorporated the specific characteristics of the assets or associated risks in the fair value measurement.

Fair value measurements should reflect market participant assumptions about **current** market conditions at the **measurement date.** We will challenge companies where historical data is used instead.

The company explains how characteristics of the assets are taken into consideration in the fair value measurement

Specialised assets are often measured on a depreciated replacement cost basis. Where this method of valuation is used we expect companies to explain:

How the amount that would be required to construct a substitute asset of equivalent utility was determined.

Adjustments for obsolescence.

Whether the highest and best use of the asset is in combination with other assets and if so, how this valuation premise was incorporated into the fair value measurement.

The fair value inputs for salmon broodstock are categorised as level 3. The broodstock contain generations of genetic improvements and cannot be valued purely on the market weight of salmon. The Group does not sell its broodstock commercially so there is no observable input in this respect. Therefore, the calculation of the estimated fair value of salmon broodstock is primarily based upon its main harvest output being salmon eggs, which are priced upon the current seasonally adjusted selling prices for the Group's salmon eggs. These prices are reduced for harvesting costs, freight costs, incubation costs and market capacity to arrive at the net value of broodstock. The valuation also reflects the internally generated data to arrive at the biomass. This includes the weight of the broodstock, the yield that each kilogram of fish will produce and mortality rates. The fish take four years to reach maturity, and the age and biomass of the fish is taken into account in the fair value. Finally, the valuation takes account of future expected sales volumes.

Benchmark Holdings plc, Annual Report and Accounts 2022, p163

3. Fair value measurements (continued)

Adjustments in fair value measurements

Valuation adjustments to the initial reference price may be made for a number of reasons. For example:

- when the quoted price for an identical asset is not representative of fair value because the volume or level of activity has significantly decreased;
- to make a similar, but not identical asset comparable to the item being measured;
- when the reference price is for a different unit of account to the item being measured;
- adjustments for risk inherent in the cash flows of an asset or liability (for example liquidity and credit risk).

Paragraph B39 of IFRS 13 explains that the appropriate adjustments for risk should be made, regardless of the valuation technique used.

We expect companies to explain significant adjustments applied in fair value measurements, the reasons for these adjustments and to quantify sensitivity where relevant (please see section 4).

Page 4 of our thematic review 'Discount Rates' explains that the effect of risk can be incorporated when applying present value techniques by either: adjusting cash flows for risk and discounting them at a risk-free rate or by discounting unadjusted cash flows at a risk-adjusted rate. Whichever approach is adopted, care must be taken to avoid double counting the effects of risk.

Incorporating credit risk in fair value measurements of financial assets and liabilities

Paragraph 43 requires that the fair value of a liability reflects the effect of non-performance risk. Non-performance risk includes, but may not be not limited to, a company's own credit risk, which is defined as the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.

Page 7 of our 'Discount rates' thematic review explains that counterparty credit risk is relevant to the measurement of financial assets at fair value (including to the initial recognition of financial assets held at amortised cost). Conversely a company's own credit risk is relevant to the fair value measurement of financial liabilities.

Companies should explain their approach for incorporating the effects of credit risk in fair value measurements where such adjustments are significant to fair value measurements. For companies in non-financial sectors, one common example is uncollateralised derivative liabilities. We may challenge companies where their approach to incorporating own credit risk is not clear.

Although less common, if a financial liability is designated at FVTPL, it will be necessary to isolate the own credit risk element as it has to be recognised in OCI.[7]

7 Unless this treatment of credit risk would create or enlarge an accounting mismatch – please see paragraphs 5.7.7 and 5.7.8 of IFRS 9

3. Fair value measurements (continued)

Climate-related matters

Climate-related matters are becoming increasingly important for investment decisions across different sectors of the economy, and investors are starting to factor such considerations into their valuations. Climate-related impacts include both physical risks (such as rising sea levels) and transition risks (such as changes in relevant legislation) which might crystallise over different time horizons and affect fair value measurements in different ways. This is a fast-evolving area and there are challenges with both the availability of data and the degree of judgement involved in assessing and quantifying the effects of climate change.

In its educational material 'Effects of climate-related matters on financial statements', the IASB makes it clear that climate-related matters may affect both the fair value measurement of assets and liabilities and the disclosures required by IFRS 13 about fair value measurements.

Page 66 of our FRC Climate thematic explains that we expect companies to consider explaining how climate change has been taken into account where investors may reasonably expect a significant impact on the fair value of an asset or liability.

Various organisations have published helpful illustrations and guidance for incorporating the risks and opportunities associated with climate change into fair value measurement. Some examples include:

- Accounting for Sustainability's framework to assess the impact of climate change on business valuations.
- The Royal Institute of Chartered Surveyors (RICS) guidance note 'Sustainability and ESG in commercial property valuation and strategic advice', which was effective from 31 January 2022.
- The Climate Disclosure Standards Board (CDSB), an international consortium of business and environmental non-governmental organisations which has now been consolidated into the IFRS Foundation, produced a paper on integrating climate-related matters into financial reporting. The paper provides two examples illustrating the incorporation of climate-related risks into the valuation of a minority interest and of customer relationships acquired in a business combination.

Where climate-related matters are material for fair value measurement, we expect companies to explain how the impact has been incorporated into fair value measurement and significant estimation uncertainty to be quantified. Simply stating that the risk has been incorporated into the fair value measurement is insufficient in such cases.

We expect companies to assess the significance of climate-related inputs (see page 18) and provide disclosures about such inputs and their sensitivity where relevant (see pages 19 and 20).

3. Fair value measurements (continued)

Valuation methodology [for investment properties, extract]

… Other factors that are taken into account include… structural and environmental conditions. With regards to the latter factor, the valuers made no explicit adjustment to their valuations as at 31 December 2021 in respect of ESG matters. However, both the Group and the valuers anticipate that ESG will have a greater influence on valuations in the future as investment markets place a greater emphasis on this topic and valuers comply with the RICS Guidance Note 'Sustainability and ESG in Commercial Property Valuation', which took effect from 31 January 2022.

Hammerson plc, 31 December 2021, p104

The company explains that whilst no specific adjustments were made in FY 2021, they expect the impact of climate-related and other ESG matters on valuations to be more significant in the future. The company also notes the new RICS guidance, which has been updated for such matters and will apply to the company's valuations in the following financial year.

4. Disclosure requirements

Disclosure objective

The standard sets out the overall disclosure objective and the minimum detailed disclosures required to satisfy this objective.

IFRS 13 requires disclosure of information that helps users to assess both:

(a) For assets and liabilities that are measured at fair value in the statement of financial position after initial recognition, **the valuation techniques** and **inputs** used to develop those measurements.

(b) For **recurring** fair value measurements using **significant unobservable inputs** (Level 3), **the effect** of the measurements on profit or loss or other comprehensive income for the period.

Measurements	What does it mean?	Example of a type of measurement
Recurring	Those that other IFRSs require or permit in the statement of financial position at the end of each reporting period.	Financial liability in respect of contingent consideration on acquisition of a business.
Non-recurring	Those that other IFRSs require or permit in the statement of financial position in particular circumstances.	Assets held for sale at fair value less costs to sell in accordance with IFRS 5.

The Appendix contains a summary of the detailed disclosure requirements.

The level of detail that needs to be disclosed depends on whether the fair value measurements are recurring or non-recurring and which level of the fair value hierarchy applies.

We expect companies to:

Consider whether their disclosures, provided in accordance with the detailed requirements of IFRS 13 and other standards, meet the overall disclosure objective of IFRS 13 and provide additional information if necessary to meet the objective.

For example, the company may disclose the following:[8]

- The nature of the item being measured at fair value, including its characteristics that are taken into account in the determination of relevant inputs.
- How third party information and relevant market data was taken into account in fair value measurement.

Apply the concept of materiality to relevant information in order to determine what should be disclosed, ensuring that key information is not lost in unnecessary detail.

8 Please see paragraph IE64 of IFRS 13 Illustrative Examples

4. Disclosure requirements (continued)

Level of aggregation / disaggregation

Companies are required to provide IFRS 13 disclosures for each class of assets and liabilities, where the class is determined on the basis of the nature, characteristics and risks. This may include differences in climate-related risks. Further disaggregation might be required for fair value measurements categorised within Level 3 of the fair value hierarchy because those measurements have a greater degree of uncertainty and subjectivity. Sufficient information must be given to enable a reconciliation of the disaggregated information to the line items presented in the statement of financial position.

We expect the level of aggregation:

- Not to obscure information about the risks associated with fair value measurements.
- To be consistent with the information provided in the rest of the ARA – for example, with the risks inherent in fair value measurements suggested by the report of the audit committee or the auditor.

Better disclosures:

- Provide the weighted average value of inputs to give an indication for the distribution of inputs within the range.
- Disaggregate significant individual fair value measurements where they are outliers in the range of the assumptions used.

Fair value hierarchy

IFRS 13 establishes a fair value hierarchy that categorises into three levels the inputs to valuation techniques used to measure fair value, and prioritises inputs as follows:

Level	Type of inputs	Example of inputs[9]
Level 1 (L1)	Quoted prices in active markets	Shares of a FTSE 100 company traded on the London Stock Exchange.
Level 2 (L2)	Observable inputs other than quoted prices within L1	For receive-fixed, pay-variable interest rate swap based on the SONIA[10] swap rate, a Level 2 input would be the SONIA swap rate if that rate is observable at commonly quoted intervals for substantially the full term of the swap.
Level 3 (L3)	Unobservable inputs	For a contingent consideration liability, a L3 input may be a probability of achieving a performance target.

The fair value measurement is categorised in its entirety in the same level of the hierarchy as the **lowest** level input that is **significant** to the entire measurement.

9 Paragraph B34 of IFRS 13
10 Sterling Overnight Index Average

4. Disclosure requirements (continued)

Level 1 categorisation is appropriate only where **all** of the following apply:

- Price is quoted in an active market.
- Price is unadjusted.
- Price is for an identical item.
- Entity can access the price at the measurement date.

If an observable input requires an **adjustment** using an unobservable input and that adjustment results in a significantly higher or lower fair value measurement, the resulting measurement would be categorised within Level 3 of the fair value hierarchy.

We consider that the significance should be assessed in the context of the **aggregate** effect on the fair value measurement, where more than one unobservable input is used in fair value measurement.

Companies should develop and consistently apply a policy for determining the significance of unobservable inputs.

We encourage companies to disclose their policy where material.

IFRS defines inputs as the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk. It follows that an adjustment to a value produced by a valuation model, represents an input, as well as the assumptions contained in the model.

Therefore, companies should consider such adjustments in determining the significance of inputs to fair value measurements and categorisation within the hierarchy.

Categorisations may change due to changes in the level of activity for an asset or a liability or unobservable inputs into fair value measurement becoming more or less observable or more or less significant.

Companies are required to disclose the level of the fair value hierarchy within which the fair value measurements are categorised in their entirety. This requirement applies for recurring and non-recurring fair value measurements and is sometimes overlooked, in particular in relation to the non-recurring measurements – for example, assets held for sale measured at fair value in accordance with the requirements of IFRS 5.

We challenge categorisation in the following cases:

L1 categorisation for instruments with no apparent quoted prices;

L2 categorisation where the company's peer group categorise similar measurements as L3;

where selection of the level appear to be inconsistent with information disclosed in the rest of the ARA about unobservable inputs that suggests a lower level within the hierarchy.

4. Disclosure requirements (continued)

IFRS 13 requires disclosures of the amounts of any transfers between the levels of the fair value hierarchy and the reasons for the transfers:

Transfers between	Required for fair value measurements
L1 and L2	on a recurring basis
L2 and L3	on a recurring and non-recurring basis

Disclosures of transfers between L1 and L2 are sometimes overlooked.

Transfers into each level are required to be disclosed separately from transfers out of each level. We often see transfers presented on a net basis.

Companies are required to disclose and consistently follow their policy for determining the timing of transfers between levels of the fair value hierarchy (for example, the date of change of circumstances that causes the transfer, the beginning of the reporting period or the end of the reporting period).

Transfers between level 3 and level 1 occur when a previously unquoted investment undertakes an initial public offering, resulting in its equity becoming quoted on an active market. In the current period, transfers of this nature amounted to £380.2m (2020: £0.4m). Transfers between level 1 and level 3 would occur when a quoted investment's market becomes inactive, or the portfolio company elects to delist. There have been no instances in the current year (2020: no such instances).

IP Group plc, 31 December 2021, p175

The company explains when transfers between the hierarchy levels occur, quantifies transfers out of Level 3 and explains that there have been no transfers into this level during the year.

Quantification of significant unobservable inputs

For L3 fair value measurements, companies are required to provide quantitative information about the significant unobservable inputs.

This is the area of the IFRS 13 requirements where we find most issues, including significant unobservable inputs or adjustments being disclosed but not quantified – for example, in relation to the fair value measurement of a contingent consideration liability.

4. Disclosure requirements (continued)

Sensitivity disclosures

The IFRS 13 requirement to provide a narrative description of sensitivity applies to the unobservable inputs used in **all** recurring L3 fair value measurements where they could result in a significantly different estimate of fair value. In addition, **quantification** of the effect of changes in unobservable inputs on measurement is required for recurring fair value measurements of **financial instruments** (for example, a contingent consideration liability).

Narrative description for all recurring L3 fair value measurements

The narrative description about sensitivity explains the directional effect of a change in a significant L3 input on a fair value measurement. That disclosure, along with quantitative information about the L3 inputs, enables users to compare the company's assumptions with their own and incorporate the company's fair value measurement in their decisions.

Companies are also required to describe any interrelationships between those inputs and other unobservable inputs and how they might magnify or mitigate the effect of changes in the unobservable inputs on the fair value measurement.

Quantitative sensitivity analysis for L3 financial instruments

In contrast, a quantitative sensitivity analysis for financial instruments that are measured at fair value and categorised within Level 3 of the fair value hierarchy, should enable users to get a sense of the potential variability of the measurement. This disclosure of sensitivity is not required to reflect interdependencies between assumptions.

IAS 1 'Presentation of Financial Statements' requirements

Fair value measurements categorised within L2 and L3 may represent major sources of estimation uncertainty within the meaning of paragraph 125 of IAS 1. Companies should consider whether the disclosures provided in compliance with IFRS 13 are sufficient to comply with the requirements of IAS 1[11] and provide additional disclosures if not. Page 13 of our thematic review on Judgements and Estimates provides an example of a good quality disclosure and explains our detailed expectations in this regard.

We are pleased that many of the large property companies provide helpful sensitivity analysis for investment property valuations.

We would challenge companies where there are indicators (in the ARA or elsewhere) that the disclosed sensitivities may not reflect the full extent of **reasonably possible alternative assumptions**, for example, where all significant unobservable inputs are sensitised by the same percentages each year.

11 Paragraph 128 explains that the disclosures are not required for fair value measurements categorised in L1 of the fair value hierarchy as changes in such fair value measurements do not arise from changes in assumptions at the end of the reporting period

4. Disclosure requirements (continued)

Example of quantitative sensitivity disclosure for financial instruments within L3 (extracts)

The fair value of the Group's investments is €2,109,569,844 (2021: €1,408,802,257). The following analysis is provided to illustrate the sensitivity of the fair value of investments to a change in an individual input, while all other variables remain constant. The Board considers these changes in inputs to be within reasonable expected ranges. This is not intended to imply the likelihood of change or that possible changes in value would be restricted to this range.

Input	Base case	Change in input	Change in fair value of investments €'000
Discount rate	6 - 7%	+0.5% -0.5%	(69,667) 74,206
Energy yield	P50	10-year P90 10-year P10	(128,748) 127,684
Power price	Forecast by leading consultant	-10% 10%	(135,947) 130,850
Inflation rate	2.0% Long term	- 0.5% +0.5%	(60,757) 64,581
Asset Life	30 years (onshore) / 35 years (offshore)	- 5 years + 5 years	(148,179) 102,394

The sensitivities above are assumed to be independent of each other. Combined sensitivities are not presented.

Greencoat Renewables PLC, 31 December 2022, page 75

It is clear that these sensitivities are considered to represent reasonably possible changes, subject to limitations of presenting information on that basis.

The company separately explains on page 74 how the base case and reasonably possible changes in inputs were determined.

The company explains in the Investment Manager's Report (on page 22) that forecasts provided by consultants are updated quarterly and may be adjusted where the investment manager considers that more conservative assumptions are appropriate.

Sensitivities are provided separately for each significant L3 input.

4. Disclosure requirements (continued)

Reconciliation of L3 fair value measurements

For recurring L3 fair value measurements, companies are required to disclose a reconciliation from the opening to the closing balances, separately disclosing changes for the period:

- Recognised in profit and loss.
- Recognised in other comprehensive income.
- Of purchases, sales, issues and settlements (each of these to be disclosed separately).
- Transfers into L3 separately from transfers out of L3 of the fair value hierarchy.

In addition, companies are required to disclose:

- The line items in which gains and losses are disclosed.
- The amount of unrealised gains and losses recognised in profit and loss.

Realised gains and losses within the meaning of IFRS 13 result from sale, disposal or settlement of an asset or a liability and therefore the asset or liability is no longer held by the company at the reporting date. Unrealised gains and losses relate to changes in the fair value of an asset or a liability that is held by the company at the reporting date.

'Unrealised gains and losses' in this context is likely to have a different meaning from that applied in the UK company law for the purposes of determining distributable profits (please see ICAEW guidance in Tech 02/17BL).

These disclosure requirements are sometimes omitted by companies in relation to some items within L3 category or in its entirety.

4. Disclosure requirements (continued)

Disclosure of valuation techniques

Companies are required to describe the valuation techniques, any changes in them and the reasons for those changes for all L2 and L3 measurements. These disclosure requirements are sometimes overlooked, particularly in relation to L2 measurements.

Disclosure of valuation processes

For fair value measurements categorised within L3, IFRS 13 requires disclosure of the valuation processes used by the company.

The extract illustrates some of the disclosures that may need to be provided to meet this disclosure requirement, which explains who is responsible for the company's policies and procedures, to whom that group reports and the internal reporting procedures in place. We encourage companies to consider illustrative example 18 of IFRS 13 in meeting this requirement.

The Valuations Committee plays a key role in providing the Board with assurance that the valuation methodology and process are robust and independently challenged. During the year, we met four times as part of the Group's external reporting timetable. We reviewed and challenged the assumptions behind management's proposed asset valuations and reported to the Audit and Compliance Committee and the Board ...

... In addition, the Committee is responsible for keeping the Group's valuation policy under review and recommending any changes to the policy to the Audit and Compliance Committee and the Board. The policy is reviewed at least annually, with the last update in April 2022. Ahead of IPEV's expected publication of revised valuation guidelines in 2022, management participated in the consultation process and on publication of these revised IPEV valuation guidelines, we will update our 3i valuation policy accordingly.

More information on our valuation methodology, including definitions and rationale, is included in the Portfolio valuation – an explanation section on pages 212 and 213.

3i Group plc, Valuations Committee report, Annual report and accounts 2022, p124-128

4. Disclosure requirements (continued)

Disclosures for assets and liabilities not measured at fair value

The disclosure requirements for assets and liabilities not measured at fair value in the statement of financial position, but for which the fair value is disclosed, are often overlooked or not fully complied with.

This disclosure requirement applies to financial assets and liabilities carried at amortised cost (with limited exceptions), investment property carried at cost; and is encouraged for property, plant and equipment carried at cost for which fair value is disclosed. Particular care must be taken with any long-term fixed rate debt given the current interest rate environment.

The following information is required to be disclosed for each class of assets and liabilities affected:

- The level of the fair value hierarchy in which an asset or a liability would be categorised if it had been measured at fair value in the statement of financial position – the aim of this requirement is to convey the relative subjectivity of fair value measurements.
- For L2 and L3 measurements a description of the valuation technique(s) and the inputs used in fair value measurement. If there has been a change in valuation technique that fact and the reasons for the change should also be provided.

In some cases, the disclosures stated that the carrying amounts were a close approximation of fair value, which was apparently inconsistent with the characteristics of the assets or the liabilities (for example, in case of a long-term fixed rate liability).

The company provides fair values for liabilities carried at amortised cost and explains how the fair values were determined.

Example of fair value disclosures for financial instruments carried at amortised cost (extract)

As at 31 December 2022 the fair values, based on unadjusted market data, of the US private placement notes was £1,063.4m (2021: £882.1m) and of the senior bonds was £572.7m (2021: £694.0m) …

Bunzl plc, 31 December 2022, p200

5. Key expectations

We expect companies to consider the examples provided of better disclosure and opportunities for improvement and incorporate them in their future reporting where relevant and material. In particular, we expect companies to:

- Ensure that fair value measurements represent market participant, rather than company-specific, assumptions and reflect the characteristics of the relevant assets, liabilities or equity instruments subject to the fair value measurements.
- Ensure that information on fair value measurements is consistent across the ARA and reflects the significant risks facing the business, including management commentary necessary to complement and further explain fair value measurements.
- Consider obtaining specialist third party advice, when the fair valuation is likely to be material and where no internal expertise exists.
- Disclose any significant estimation uncertainty in relation to fair value measurements.
- As a minimum provide disclosures required by the standard, including the following information for the recurring Level 3 measurements: quantitative information about significant unobservable inputs and adjustments, quantitative sensitivity for financial instruments and a reconciliation of movements in fair value.
- Provide additional information where this is necessary to meet the overall disclosure objective of the standard, not just the specific requirements, and avoid boilerplate and immaterial information.
- Explain how management considered climate-related matters in fair value measurements where this information is material.
- Ensure that the level of aggregation of information on fair value measurements results in useful disclosures.

6. Appendix: summary of IFRS 13 disclosure requirements[12]

Disclosure requirements	Item measured at fair value						Item measured at cost, but for which fair value is disclosed[15]		
	Recurring[13]			Non-recurring[14]					
	L1	L2	L3	L1	L2	L3	L1	L2	L3
Fair value at end of reporting period	✓	✓	✓	✓	✓	✓	✓	✓	✓
Reasons for measurement				✓	✓	✓			
Level within fair value hierarchy	✓	✓	✓	✓	✓	✓	✓	✓	✓
Transfers between the levels in the hierarchy	✓	✓	✓						
Policy for determining when transfers between hierarchy have occurred	✓	✓	✓						
Description of valuation technique and inputs used		✓	✓		✓	✓		✓	✓
Changes to valuation technique and reasons		✓	✓		✓	✓		✓	✓
Quantitative information about significant unobservable inputs			✓						
Reconciliation of opening and closing balance (including information on transfers in or out)			✓						
Unrealised gains / losses recognised in profit or loss			✓						
Description of valuation processes and policies			✓			✓			
Sensitivity to changes in unobservable inputs (narrative)			✓						
Sensitivity to reasonably possible change in assumptions (quantitative, for financial instruments only)			✓						
If highest and best use differs from current use, reasons why (non-financial assets only)	✓	✓	✓	✓	✓	✓	✓	✓	✓
If portfolio exception in paragraph 48 is applied (financial instruments only)	✓	✓	✓						

12 https://www.ifrs.org/content/dam/ifrs/meetings/2017/october/cmac/ap5a-appendices-fair-value-measurement-pir.pdf
13 Where IFRS Standards require or permit fair value measurement at the end of each reporting period (applicable to financial instruments, property, plant & equipment, intangible assets, investment property and agricultural assets carried at fair value)
14 Where IFRS Standards require or permit fair value measurement in particular circumstances (for example: fair value measurements of assets held for sale)
15 Paragraph 25 of IFRS 7 'Financial Instruments: Disclosures', paragraph 79(d) of IAS 16 and paragraph 79(e) of IAS 40

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