Staff Paper

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| Project | **Insurance contracts** |
| Topic | **Risk adjustment: comparability and verifiability through disclosure** |

## Purpose of this paper

1. This paper discusses the disclosures needed to achieve comparability and verifiability for a risk adjustment.

## Summary of staff recommendation

2. Staff recommend that the boards
   (a) withdraw the proposal in paragraph 90(b)(i) of the ED to disclose information about the confidence level to which the risk adjustment estimated using a conditional tail expectation technique or a cost of capital technique corresponds.
   (b) not to confirm the measurement uncertainty analysis at this stage, but to consider that disclosure as part of the planned work for fair value measurement.
   (c) confirm the proposals in paragraph 90(a)-(c) of the ED that an insurer should disclose, for the risk adjustment:

      90…

      (a) the methods used and the processes for estimating the inputs to those methods. When practicable, the insurer shall also provide quantitative information about those inputs.

      (b) to the extent not covered in (a), the methods and inputs used to estimate the risk adjustment.

This paper has been prepared by the technical staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

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(c) the effect of changes in the inputs used to measure insurance contracts showing separately the effects of each change that has a material effect on the financial statements.

## What this paper is about?

3. In this paper, staff address the issue of comparability and verifiability of the information provided with a risk adjustment by considering the disclosures that complement the application of a risk adjustment technique.

4. As shown in agenda paper 3C/68C *Risk adjustment: techniques to meet the objective*, achieving comparability and, at the same time, ensuring that the risk adjustment provides relevant information is not likely to be achieved by looking in isolation at the techniques to determine the risk adjustment. Instead, we consider how other aspects of the proposed model to account for insurance contracts can support the comparability and verifiability of the quantification of the risk adjustment. In order to do so, this paper investigates the proposed requirement to disclose the methods and inputs used to develop the measurements, specifically the proposal to disclose the confidence level equivalent (paragraphs 21-27).

5. This paper considers only those disclosures which directly support the comparability and verifiability of the estimation of the risk adjustment. Therefore, this paper does not discuss the disclosure objective and the other disclosures. The disclosure objective and principles are discussed in agenda paper 3I/68I *Disclosures: application of cross-cutting analysis*. We will discuss other disclosures at a future meeting.

## Background

### *Summary of the IASB's proposals*

6. Paragraph 90 of the ED requires disclosure of the methods and inputs used to develop the measurement, specifically for risk adjustment, discount rate and estimates of policyholder dividends. As applied to risk adjustment, paragraph 90 proposes that an insurer shall disclose:

**[…]**

**(a) for the measurements that have the most material effect on the recognised amounts arising from insurance contracts, the methods used and the processes for estimating the inputs to those methods. When practicable, the insurer shall also provide quantitative information about those inputs.**

**(b) to the extent not covered in (a), the methods and inputs used to estimate:**

**(i) the risk adjustment, including information about the confidence level to which the risk adjustment corresponds. If the insurer uses a conditional tail expectation technique or a cost of capital technique, it shall disclose the confidence level to which the risk adjustment estimated under those methods corresponds (eg that the risk adjustment was estimated at conditional tail expectation (Y) and corresponds to a confidence level of Z per cent).**

**...**

**(d) a measurement uncertainty analysis of the inputs that have a material effect on the measurement. If changing one or more inputs used in the measurement to a different amount that could have reasonably been used in the circumstances would have resulted in a materially higher or lower measurement, the insurer shall disclose the effect of using those different amounts and how it calculated that effect. When preparing a measurement uncertainty analysis, an insurer shall not take into account inputs that are associated with remote scenarios. An insurer shall take into account the effect of correlation between inputs if such correlation is relevant when estimating the effect on the measurement of using those different amounts. For that purpose, materiality shall be judged with respect to profit or loss, and total assets or total liabilities.**

7. The basis for conclusions notes in paragraph BC243:

**The Board used the disclosure requirements in IFRS 4 (including the disclosure requirements in IFRS 7 that are incorporated in IFRS 4 by crossreference) as a basis for its proposals. In addition, the Board proposes to include the following items in the draft IFRS:**

**…**

**(b) (ii) a more detailed explanation of methods, inputs and processes used in the measurement. Because the proposed measurement for insurance contracts is a current measure of items that may be difficult to measure, the transparency of the inputs and methods**

**used is important to users of the financial statements (see paragraph 90(a)).**

**(iii) a translation of risk adjustments into a confidence level for disclosure, even if the insurer had not used that technique to determine the risk adjustment (ie if the insurer used a conditional tail expectation or a cost of capital technique). That disclosure would enhance comparability among insurers (see paragraphs 90(b), BC116 and BC117).**

**(iv) a measurement uncertainty analysis. This would inform users about the extent to which the insurer might reasonably have arrived at different measurements (see paragraph 90(d)).**

8. Furthermore, paragraph BC117 of the basis for conclusions clarifies that the IASB intended to provide comparability regarding the measurement of the risk adjustment by setting three specific requirements (which we refer to as *three pillars* in agenda paper 3C/68C *Risk adjustment: techniques to meet the objective*), including the disclosure of the confidence level equivalent, as follows:

> **... the Board concluded that permitting a wide range of techniques to determine the risk adjustment could lead to diversity in practice, which might reduce the relevance of the resulting measurement and make it difficult for users to compare risk adjustments made by different insurers. Accordingly, the draft IFRS proposes:**
>
> **(a) to state a principle for determining the risk adjustment.**
>
> **(b) to specify that only three techniques are permitted as a means of complying with that principle, and to provide guidance to help insurers assess when each of those techniques is more likely to be appropriate.**
>
> **(c) that an insurer should translate its risk adjustments into a confidence level for disclosure, even if the insurer has used one of the other two permitted techniques to determine the risk adjustment. That disclosure would enhance comparability among insurers.**

***Relevant questions in the exposure draft / discussion paper***

9. Questions 5(c) and 14(c) of the ED asked respondents the following:

> Do you agree that if either the CTE or the cost of capital method is used, the insurer should disclose the confidence level to which the risk adjustment corresponds (see paragraph 90(b)(i))? Why or why not?

> Are there any disclosures that have not been proposed that would be useful (or some proposed that are not)? If so, please describe those disclosures and explain why they would or would not be useful.

10. Question 31 of the DP asked respondents the following:

> Do you agree with the proposed disclosures in the IASB's Exposure Draft? Why or why not? If not, what would you recommend and why?

***Overview of comments on the ED relating to the risk adjustment disclosures***

11. Respondents did not generally comment on the disclosure proposed in paragraph 90, except to state that the disclosure of measurement uncertainty is unduly onerous.

12. Some respondents thought that the disclosure of the confidence level equivalent would provide useful information on an insurer's approach in managing risks and would promote comparability of risk margins measured by different insurers because it would refer to the technique – ie confidence intervals – which is most readily understood by users of financial statements. These respondents, including some of those that favour a composite margin approach, suggest that this disclosure should be accompanied by information regarding the method used to estimate the risk adjustment and the reason for selecting that method.

*Comparability of information and role of disclosures*

13. On the comparability of information and the role of disclosures one respondent commented that:

*[…] we do not believe that it should be prescribed that entities with similar risks must have comparable risk adjustment margins. We would rather see a situation where management decides the appropriate level of the risk margin along with*

*robust disclosures concerning the entity's approach to measuring and managing risk which would allow users of financial statements to draw individual conclusions about entities' risk adjustment margins.*

14. One respondent suggested that a possible alternative would be to require insurers to disclose information regarding the relative magnitude of the risk adjustment rather than prescribing the use of a confidence level equivalent.

15. Also, some respondents that favoured the proposed disclosure of confidence level said that its relevance would depend on the extent to which the boards will provide guidance around the inputs to the confidence level calculation, such as the impact of correlations in the determination of the risk adjustment under this technique. One respondent noted that disclosing the confidence level equivalent would enhance comparability only if it were disclosed at an entity level, so as to acknowledge the full diversification effects arising for an insurer. This respondent commented as follows:

    *The confidence level corresponding to a given risk adjustment depends on the way in which the business is structured in portfolios, reinsurance arrangements and the degree of diversification recognised. As a result, confidence levels for individual portfolios are unlikely to be comparable, either within or between insurers. […] Because net capital requirements at the whole entity level are broadly comparable, however, the confidence level corresponding to the total net provisions for the entity is likely to prove useful. We therefore recommend that this disclosure only be required on this net whole-entity basis.*

16. Although the boards intended the proposed disclosure to require the translation into a confidence level equivalent of the *output* of either a CTE or a cost of capital technique, some misinterpreted this proposal as requiring entities to disclose the confidence level which is used as *input* in the measurement of the risk adjustment under either a CTE or cost of capital technique. It was based on this misinterpretation that some respondents concluded that this disclosure:

    (a) does not impose additional burdens on insurers; and

    (b) provides information on the level of prudence adopted by an insurer in setting the risk adjustment which would be more akin to a regulatory type of information.

*Usefulness of confidence level disclosure*

17. Most respondents believed that the requirement to disclose the confidence level equivalent would not add comparability because that could only be achieved if different insurers used the same underlying probability distribution to measure the risk adjustment. Even then, the information provided by this disclosure would be relevant to users only if:

    (a) the underlying distribution were not particularly skewed; and

    (b) specific requirements are set to indicate how correlations (and the related diversification benefits) should be factored into the confidence level calculation.

18. Some commentators suggested that this requirement would result in:

    (a) a duplication of the efforts which would be necessary for determining risk adjustments. Respondents doubted the benefit of this duplication.

    (b) a false impression of precision because CTE or CoC techniques already involve some uncertainty in the selection of the underlying assumptions and parameters and this uncertainty would increase as a result of the translation of the risk adjustment to confidence levels.

    (c) the risk of irrelevant information if entities ultimately choose to apply the confidence level technique to avoid the extra costs involved in a double calculation of the risk adjustment, even when the characteristics of the underlying cash flow distribution would make that technique less appropriate (eg if the probability distribution presents fat tails, as discussed in paragraph B95 of the ED).

    (d) a false impression that confidence level techniques are the techniques favoured by the boards.

19. Some commentators said that, at present, no widely accepted technique has been developed to translate risk adjustments determined under CTE or CoC into confidence levels and that this exercise might result in divergence in practice and in the disclosure of information that is more uncertain, rather than more comparable. However, at one of the risk adjustment education sessions, one of the presenters stated that it would be straightforward to do this translation.

20. Most respondents suggested that comparability of the risk adjustment should be achieved instead by disclosing:

    (a) the technique(s) applied;

    (b) reasons for choosing a specific technique;

    (c) changes in significant assumptions; and

    (d) measurement uncertainty and sensitivity analysis.

## Staff analysis and recommendations

21. Staff believe that most of the issues around comparability and verifiability that relate to the determination of the degree of confidence that users can place on the estimate of a risk adjustment relate to the following factors:

    (a) a risk adjustment is an estimate that aims to depict an entity-specific phenomenon and is largely based on unobservable inputs – ie the economic burden that uncertainty and the related risk impose on insurer.

    (b) estimation of a risk adjustment involves some **subjectivity**. However, it needs not be **arbitrary**. On one hand, the concept of **arbitrariness** refers to something that it is 'based on random choice or personal whim, rather than any reason or system'; on the other hand, the concept of **subjectivity** refers to something that it is 'dependent on the mind or on an individual's perception for its existence'.

22. There are three premises to our analysis of these issues, as follows:

    (a) The proposed requirement to disclose a confidence level equivalent does not satisfy the objective of providing comparable information. However, other disclosures can help achieve comparability for the risk adjustment.

    (b) The determination of a risk adjustment depends on unobservable, subjective and entity-specific inputs. In this respect, there is commonality with IFRS 13, which accepts that entities may need to estimate fair value using unobservable and subjective inputs (which may be developed on the basis of entity-specific information, but must be adjusted if there is evidence that market participants would use different assumptions) (on level 3 of the fair value hierarchy).

(c) Disclosures also have a role in enhancing the verifiability of the risk adjustment.

***'Pick a number': confidence level disclosures***

23. The boards' concerns that the risk adjustment could result in the presentation of arbitrary information on the face of the financial statements resulted in the proposals (a) to limit the range of available techniques; and (b) to translate this adjustment, where calculated under CTE and CoC, into the equivalent confidence level.

24. An estimate of a risk adjustment inherently involves some degree of subjectivity. If the boards intended the proposed disclosure requirement to introduce an element of discipline in the process of making that subjective estimate, the confidence level equivalent is not likely to achieve this objective, particularly since there is no single generally accepted technique to perform this translation into the confidence level equivalent.

25. Some boards members expressed their concern at what they viewed as the arbitrariness involved in measuring the risk adjustment by using the expression 'Pick a number' to highlight that entities would have been left free to choose their own risk adjustment, if the boards were not to impose any boundaries around its measurement.

26. To paraphrase this expression, we shall say that the majority of respondents thought that this disclosure requirement would result in 'Pick two numbers', ie in a duplication of the degree of arbitrariness around the risk adjustment.

27. Based on the above considerations and the feedback received, staff believe that requiring entities to estimate and disclose the confidence level equivalent would be inconsistent with an approach that aims at providing comparability of the measurement of the risk adjustment by making its estimation process transparent. Staff therefore recommend that the boards remove the proposed requirement to disclose the confidence level equivalent.

| **Question 1 – Remove the requirement to disclose confidence level equivalent** |
|---|
| Do the boards agree:<br><br>(a) not to require specific disclosure of information about the confidence level to which the risk adjustment corresponds? |

(b) not to require disclosures of the confidence level to which the risk adjustment estimated under a conditional tail expectation technique or a cost of capital technique, if an insurer uses those methods?

***Disclosures needed to promote comparability: Methods and inputs used to develop the measurements***

28. In paragraph 22(b) and in agenda paper 3C/68C *Risk adjustment: techniques to meet the objective* we draw the comparison between Level 3 inputs in the context of the fair value measurement and the inputs that feed a risk adjustment measurement model under a fulfilment notion.

29. In staff's view, the concerns about comparability and verifiability for the risk adjustment in measuring insurance contract liabilities are equally applicable to measuring fair value when using unobservable inputs. Accordingly, the staff think that disclosures that refer to measurement of the risk adjustment (and, similarly, to the measurement of other building blocks, where unobservable inputs are used) should be consistent with that in IFRS 13 and that the boards should not require more (or less) disclosure for a risk adjustment than for Level 3 fair value measurements. Extracts from the disclosure requirements in IFRS 13 for measurements based on unobservable inputs and the Basis for Conclusions to IFRS 13 are reproduced in appendices B and C respectively.

30. The *Conceptual Framework for Financial Reporting* (the Framework) provides guidance about the type of information needed to provide comparability in QC21, QC24 and QC15 as follows (emphasis added):

> **Q21 Comparability is the qualitative characteristic *that enables users to identify and understand similarities in, and differences among, items.* […]**
>
> **Q24 Some degree of comparability is likely to be attained by satisfying the fundamental qualitative characteristics. A faithful representation of a relevant economic phenomenon should naturally possess some degree of comparability with a faithful representation of a similar relevant economic phenomenon by another reporting entity.**
>
> **Q25 Faithful representation does not mean accurate in all respects. [...] an estimate of an unobservable price or value cannot be determined to be accurate or inaccurate. However, *a representation of that estimate can be faithful if***

> ***the amount is described clearly and accurately as being an estimate, the nature and limitations of the estimating process are explained, and no errors have been made in selecting and applying an appropriate process for developing the estimate.***

31. This implies that, if the risk adjustment is to provide relevant information, users need enough explanation to be able to understand:
    (a) the assumptions the insurer has factored in the estimation model it has used; and
    (b) the degree of subjectivity involved in the measurement.

32. Staff believe that providing disclosure that allows users to understand those two features of the measurement of the risk adjustment would permit comparability of information. By *opening up* the process an entity uses to measure the risk adjustment, users could form their own judgement regarding the differences and the similarities, and ultimately the pros and cons of one valuation process compared to another. Such an approach gives transparency to the process used to measure the risk adjustment.

33. Staff also notes that the disclosure requirements proposed in the ED are already broadly consistent with those in IFRS 13 where these relate to measurements that use unobservable inputs (except for the requirement in IFRS 13 to disclose a change in the valuation technique used in a fair value measurement – which we will discuss at a future meeting). The disclosures proposed in the ED were based on similar disclosures in IFRS 4. Appendix A illustrates the similarities between those disclosures. Furthermore, staff note that IFRS 13 does not distinguish inputs used in determining adjustments for risk from other types of inputs, but rather it makes a distinction between fair value measurements based on observable inputs and those based on unobservable inputs.

### *Disclosures needed for verifiability*

34. The *Framework* discusses how disclosures can to add verifiability to the measurement. QC26 – QC28 state (emphasis added):

> **QC26 […] Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation. Quantified information**

**need not be a single point estimate to be verifiable. A range of possible amounts and the related probabilities can also be verified.**

**QC27 Verification can be direct or indirect. [...]Indirect verification means *checking the inputs to a model, formula or other technique and recalculating the outputs using the same methodology*. An example is verifying the carrying amount of inventory by checking the inputs (quantities and costs) and recalculating the ending inventory using the same cost flow assumption (for example, using the first-in, first-out method).**

**QC28 It may not be possible to verify some explanations and forward-looking financial information until a future period, if at all. To help users decide whether they want to use that information, *it would normally be necessary to disclose the underlying assumptions*, *the methods of compiling the information and other factors and circumstances that support the information.***

35. We can summarise that to help add verifiability to the measurement of the risk adjustment, disclosure needs to provide users with the inputs and assumptions used in the technique. These conclusions are consistent with those of the boards when developing IFRS 13, which states:

**The boards noted that the objective of the disclosure is not to enable users of financial statements to replicate the entity's pricing models, but to provide enough information for users to assess whether the entity's views about individual inputs differed from their own and, if so, to decide how to incorporate the entity's fair value measurement in their decisions. [see IFRS 13.BC192]**

### *Measurement uncertainty analysis*

36. As noted in paragraph 11, respondents believed that the measurement uncertainty analysis proposed in the ED would be unduly onerous. Those views were consistent with the comments received on a similar requirement in fair value measurement, as described in paragraphs BC202-BC210 of the Basis for Conclusions to IFRS 13, reproduced in Appendix C. As discussed above, we believe that similar disclosures should apply to the risk adjustment as to fair value measurement. In finalising IFRS 13, the boards decided not to require a measurement uncertainty analysis disclosure at this time because of concerns about costs relative to benefits. However, the boards asked the staff to assess whether a quantitative measurement uncertainty

analysis disclosure would be practical after issuing IFRS 13, with the aim of reaching a conclusion at a later date about whether to require such a disclosure. As a result, the boards decided to require more quantitative information about the inputs and narrative information about how those inputs influence the measurement (as described in paragraphs BC188-BC195 and BC206 of the Basis for Conclusions to IFRS 13, reproduced in Appendix C).

37. We propose that the boards should have consistent requirements for measurement uncertainty in the insurance contracts standard and in IFRS 13. Therefore we think the boards should apply to the measurement uncertainty analysis for the risk adjustment the same conclusion that they intend to develop for the measurement uncertainty analysis disclosure in IFRS 13.

***Conclusions***

38. In this paper, we have discussed the need for disclosure about the methods and inputs used in the measurement of the risk adjustment and the fact that respondents were generally supportive of the disclosure about risk adjustments (based on IFRS 4) proposed in the ED, except on measurement uncertainty. For measurement uncertainty analysis, we note that some of the concerns raised were considered in determining whether to require a measurement uncertainty analysis in IFRS 13.

39. Accordingly, the staff recommends that the boards confirm the disclosures in paragraph 90 of the ED, modified:

    (a) to exclude the confidence level disclosure as discussed in paragraphs 23-27; and

    (b) to align (in due course) the measurement uncertainty analysis with that for fair value measurements.

| **Question 2 – Set of disclosures that promote comparability, verifiability and understandability** |
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| Do the boards confirm an insurer should disclose for the risk adjustment:<br><br>(a) the methods used and the processes for estimating the inputs to those methods. When practicable, the insurer shall also provide quantitative information about those inputs. |

(b) to the extent not covered in (a), the methods and inputs used to estimate the risk adjustment

(c) the effect of changes in the inputs used to measure insurance contracts showing separately the effects of each change that has a material effect on the financial statements?

Do the boards agree not to confirm the measurement uncertainty analysis at this stage, but to consider that disclosure as part of the planned work for fair value measurement?

## Appendix A: Comparison of ED proposals with IFRS 13 *Fair Value Measurement*

When entities measure fair value based on unobservable (level 3) inputs, IFRS 13 requires disclosure of information about how the entity developed the measurement. The following table compares the relevant disclosure requirements in draft IFRS 13 with those proposed in the ED.

| Disclosure in IFRS 13 (for Level 3) | | Disclosures proposed in ED | | Comment[1] |
|---|---|---|---|---|
| 91 | A description of the valuation technique(s) and the inputs used in the fair value measurement | 85(b) | the methods and inputs used to develop the measurements | The requirements are similar, although IFRS 13 uses the term 'valuation techniques' rather than 'methods'. |
| 93(d) | If there has been a change in valuation technique (eg changing from a market approach to an income approach or the use of an additional valuation technique), the entity shall disclose that change and the reason(s) for making it. | n/a | | The ED does not provide for the circumstance where a valuation technique is changed.<br>The requirements associated with this aspect will be treated at a future meeting together with changes in inputs and methods that relate to the other building blocks. |
| 93(d) | Quantitative information about the significant unobservable inputs used in the fair value measurement. […] However, when providing this disclosure an entity cannot ignore quantitative unobservable inputs that are significant to the fair | 90(a) | for the measurements that have the most material effect on the recognised amounts arising from insurance contracts, the methods used and the processes for estimating the inputs to those methods. When practicable, | No substantive difference. The ED not only requires disclosure of the 'methods' used, but for the 'most relevant measurements' (this includes the risk adjustment and its |

[1] We have assumed that the disclosures in the insurance contracts standard will retain consistency with the disclosures in the standards on revenue recognition and leases. We note that IFRS 13 contains other disclosures relevant to Level 1 and Level 2 fair value measurements.

| Disclosure in IFRS 13 (for Level 3) | Disclosures proposed in ED | Comment[1] |
|---|---|---|
| value measurement and are reasonably available to the entity.<br><br>93(g) A description of the valuation processes used by the entity (including, for example, how an entity decides its valuation policies and procedures and analyses changes in fair value measurements from period to period). | the insurer shall also provide quantitative information about those inputs.<br><br>90(b) to the extent not covered in (a), the methods and inputs used to estimate: (i) the risk adjustment […] | unobservable inputs) it also requires disclosure of the processes for estimating the inputs to these methods.<br><br>IFRS 13 focuses on the 'unobservable inputs' used in the measurement, while the ED more generically refers to the 'inputs'. However, as the inputs for determining the risk adjustment are generally unobservable, there is no substantive difference in relation to the risk adjustment.<br><br>IFRS 13 requires disclosure of the 'valuation processes used by the entity', while the ED focuses on the processes to estimate the inputs. That means IFRS 13 is broader than the ED in this respect. |
| N/A | 90(c) the effect of changes in the inputs used to measure insurance contracts showing separately the effects of each change that has a material effect on the financial statements. | This requirement was carried over from paragraph 37(d) of IFRS 4. It was not identified as problematic in the responses to the ED. |
| 93(e) A reconciliation from the opening balances to the closing balances, disclosing separately changes during the period attributable to the following: […] | 86 To comply with paragraph 85(a), an insurer shall disclose a reconciliation from the opening to the closing balance of each of the following, if applicable: […] (e) risk adjustments […]. | The reconciliation requirements are broadly consistent between the ED and IFRS 13. (This requirement is discussed in Agenda Paper 3I/68I *Disclosures: Application of cross-cutting analysis*) |

## Appendix B: Disclosures in IFRS 13 *Fair Value Measurement*

This appendix reproduces the disclosures in IFRS 13.

## Disclosure

**91** **An entity shall disclose information that helps users of its financial statements assess both of the following:**

(a) **for assets and liabilities that are measured at fair value on a recurring or non-recurring basis 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.**

92 To meet the objectives in paragraph 91, an entity shall consider all of the following:

(a) the level of detail necessary to satisfy the disclosure requirements;

(b) how much emphasis to place on each of the various requirements;

(c) how much aggregation or disaggregation to undertake; and

(d) whether users of financial statements need additional information to evaluate the quantitative information disclosed.

If the disclosures provided in accordance with this IFRS and other IFRSs are insufficient to meet the objectives in paragraph 91, an entity shall disclose additional information necessary to meet those objectives.

93 To meet the objectives in paragraph 91, an entity shall disclose, at a minimum, the following information for each class of assets and liabilities (see paragraph 94 for information on determining appropriate classes of assets and liabilities) measured at fair value (including measurements based on fair value within the scope of this IFRS) in the statement of financial position after initial recognition:

(a) for recurring and non-recurring fair value measurements, the fair value measurement at the end of the reporting period, and for non-recurring fair value measurements, the reasons for the measurement. Recurring fair value measurements of assets or liabilities are those that other IFRSs require or permit in the statement of financial position at the end of each reporting period. Non-recurring fair value measurements of assets or liabilities are those that other IFRSs require or permit in the statement of financial position in particular circumstances (eg when an entity measures an asset held for sale at fair value less costs to sell in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* because the asset's fair value less costs to sell is lower than its carrying amount).

(b) for recurring and non-recurring fair value measurements, the level of the fair value hierarchy within which the fair value measurements are categorised in their entirety (Level 1, 2 or 3).

(c) for assets and liabilities held at the end of the reporting period that are measured at fair value on a recurring basis, the amounts of any transfers between Level 1 and Level 2 of the fair value hierarchy, the reasons for those transfers and the entity's policy for determining when transfers between levels are deemed to have occurred (see paragraph 95). Transfers into each level shall be disclosed and discussed separately from transfers out of each level.

(d) for recurring and non-recurring fair value measurements categorised within Level 2 and Level 3 of the fair value hierarchy, a description of the valuation technique(s) and the inputs used in the fair value measurement. If there has been a change in valuation technique (eg changing from a market approach to an income approach or the use of an additional valuation technique), the entity shall disclose that change and the reason(s) for making it. For fair value measurements categorised within Level 3 of the fair value hierarchy, an entity shall provide quantitative information about the significant unobservable inputs used in the fair value measurement. An entity is not required to create quantitative information to comply with this disclosure requirement if quantitative unobservable inputs are not developed by the entity when measuring fair value (eg when an entity uses prices from prior transactions or third-party pricing information without adjustment). However, when providing this disclosure an entity cannot ignore quantitative unobservable inputs that are significant to the fair value measurement and are reasonably available to the entity.

(e) for recurring fair value measurements categorised within Level 3 of the fair value hierarchy, a reconciliation from the opening balances to the closing balances, disclosing separately changes during the period attributable to the following:

(i) total gains or losses for the period recognised in profit or loss, and the line item(s) in profit or loss in which those gains or losses are recognised.

(ii) total gains or losses for the period recognised in other comprehensive income, and the line item(s) in other comprehensive income in which those gains or losses are recognised.

(iii) purchases, sales, issues and settlements (each of those types of changes disclosed separately).

(iv) the amounts of any transfers into or out of Level 3 of the fair value hierarchy, the reasons for those transfers and the entity's policy for determining when transfers between levels are deemed to have occurred (see paragraph 95). Transfers into Level 3 shall be disclosed and discussed separately from transfers out of Level 3.

(f) for recurring fair value measurements categorised within Level 3 of the fair value hierarchy, the amount of the total gains or losses for the period in (e)(i) included in profit or loss that is attributable to the change in unrealised gains or losses relating to those assets and liabilities held at the end of the reporting period, and the line item(s) in profit or loss in which those unrealised gains or losses are recognised.

(g) for recurring and non-recurring fair value measurements categorised within Level 3 of the fair value hierarchy, a description of the valuation processes used by the entity (including, for example, how an entity decides its valuation policies and procedures and analyses changes in fair value measurements from period to period).

(h) for recurring fair value measurements categorised within Level 3 of the fair value hierarchy:

(i) for all such measurements, a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs if a change in those inputs to a different amount might result in a significantly higher or lower fair value measurement. If there are interrelationships between those inputs and other unobservable inputs used in the fair value measurement, an entity shall also provide a description of those interrelationships and of how they might magnify or mitigate the effect of changes in the unobservable inputs on the fair value measurement. To comply with that disclosure requirement, the narrative description of the sensitivity to changes in unobservable inputs shall include, at a minimum, the unobservable inputs disclosed when complying with (d).

(ii) for financial assets and financial liabilities, if changing one or more of the unobservable inputs to reflect reasonably possible alternative assumptions would change fair value significantly, an entity shall state that fact and disclose the effect of those changes. The entity shall disclose how the effect of a change to reflect a reasonably possible alternative assumption was calculated. For that purpose, significance shall be judged with respect to profit or loss, and total assets or total liabilities, or, when changes in fair value are recognised in other comprehensive income, total equity.

(i) for recurring and non-recurring fair value measurements, if the highest and best use of a non-financial asset differs from its current use, an entity shall disclose that fact and why the non-financial asset is being used in a manner that differs from its highest and best use.

94 An entity shall determine appropriate classes of assets and liabilities on the basis of the following:

(a) the nature, characteristics and risks of the asset or liability; and

(b) the level of the fair value hierarchy within which the fair value measurement is categorised.

The number of classes may need to be greater for fair value measurements categorised within Level 3 of the fair value hierarchy because those measurements have a greater degree of uncertainty and subjectivity. Determining appropriate classes of assets and liabilities for which disclosures about fair value measurements should be provided requires judgement. A class of assets and liabilities will often require greater disaggregation than the line items presented in the statement of financial position. However, an entity shall provide information sufficient to permit reconciliation to the line items presented in the statement of financial position. If another IFRS specifies the class for an asset or a liability, an entity may use that class in providing the disclosures required in this IFRS if that class meets the requirements in this paragraph.

95 An entity shall disclose and consistently follow its policy for determining when transfers between levels of the fair value hierarchy are deemed to have occurred in accordance with paragraph 93(c) and (e)(iv). The policy about the timing of recognising transfers shall be the same for transfers into the levels as for transfers out of the levels. Examples of policies for determining the timing of transfers include the following:

(c) the date of the event or change in circumstances that caused the transfer.

(d) the beginning of the reporting period.

(e) the end of the reporting period.

96 If an entity makes an accounting policy decision to use the exception in paragraph 48, it shall disclose that fact.

97 For each class of assets and liabilities not measured at fair value in the statement of financial position but for which the fair value is disclosed, an entity shall disclose the information required by paragraph 93(b), (d) and (i). However, an entity is not required to provide the quantitative disclosures about significant unobservable inputs used in fair value measurements categorised within Level 3 of the fair value hierarchy required by paragraph 93(d). For such assets and liabilities, an entity does not need to provide the other disclosures required by this IFRS.

98 For a liability measured at fair value and issued with an inseparable third-party credit enhancement, an issuer shall disclose the existence of that credit enhancement and whether it is reflected in the fair value measurement of the liability.

99 An entity shall present the quantitative disclosures required by this IFRS in a tabular format unless another format is more appropriate.

# Appendix C: Extract from Basis for Conclusions to IFRS 13

*This appendix reproduces the relevant disclosure paragraphs of the Basis for Conclusions to IFRS 13.*

## Information about fair value measurements categorised within Level 3 of the fair value hierarchy

BC187 The boards received requests from users of financial statements for more information about fair value measurements categorised within Level 3 of the fair value hierarchy. The following sections describe the boards' response to those requests.

### *Quantitative information*

BC188 The exposure draft proposed requiring an entity to disclose the methods and inputs used in a fair value measurement, including the information used to develop those inputs. That proposal was developed using feedback from users of financial statements and the IASB's Fair Value Expert Advisory Panel. Although the proposal was not explicit, the IASB intended that the information about the inputs used in the measurement would be quantitative.

BC189 Before the amendments to Topic 820, US GAAP required an entity to provide a description of the inputs used when measuring the fair value of an asset or a liability that is categorised within Level 2 or Level 3 of the fair value hierarchy. Topic 820 was not explicit about whether that description needed to include quantitative information.

BC190 Users of financial statements asked the boards to clarify that entities must provide quantitative information about the inputs used in a fair value measurement, particularly information about unobservable inputs used in a measurement categorised within Level 3 of the fair value hierarchy. When limited or no information is publicly available, disclosures about such information help users to understand the measurement uncertainty inherent in the fair value measurement.

BC191 Therefore, the boards decided to clarify that an entity should disclose *quantitative* information about the significant unobservable inputs used in a fair value measurement categorised within Level 3 of the fair value hierarchy.

BC192 Some respondents to the FASB's proposed ASU questioned the usefulness of quantitative information about the unobservable inputs used in a fair value measurement because of the level of aggregation required in those disclosures. The boards noted that the objective of the disclosure is not to enable users of financial statements to replicate the entity's pricing models, but to provide enough information for users to assess whether the entity's views about individual inputs differed from their own and, if so, to decide how to incorporate the entity's fair value measurement in their decisions. The boards concluded that the information required by the disclosure will facilitate comparison of the inputs used over time, providing users with information about changes in management's views about particular unobservable inputs and about changes in the market for the assets and liabilities within a particular class. In addition, that disclosure might facilitate comparison between entities with similar assets and liabilities categorised within Level 3 of the fair value hierarchy.

BC193 IFRS 13 and Topic 820 state that an entity should determine appropriate classes of assets and liabilities on the basis of the nature, characteristics and risks of the assets and liabilities, noting that further disaggregation might be required for fair value measurements categorised within Level 3 of the fair value hierarchy. Consequently, the boards concluded that the meaningfulness of the disclosure of quantitative information used in Level 3 fair value measurements will depend on an entity's determination of its asset and liability classes.

BC194 Some respondents to the IASB's re-exposure document and the FASB's proposed ASU suggested requiring quantitative information about the unobservable inputs used in fair value measurements categorised within Level 2 of the fair value hierarchy because determining whether to categorise fair value measurements within Level 2 or Level 3 can be subjective. The boards concluded that for a fair value measurement to be categorised within Level 2 of the fair value hierarchy, the unobservable inputs used, if any, must not be significant to the measurement in its entirety. As a result, the boards decided that quantitative information about unobservable inputs would be of limited use for those measurements.

BC195 In addition, the boards understand that fair value is sometimes measured on the basis of prices in prior transactions (eg adjustments to the last round of financing for a venture capital investment) or third-party

pricing information (eg broker quotes). Such measurements might be categorised within Level 3 of the fair value hierarchy. In such cases, the boards concluded that an entity should be required to disclose how it has measured the fair value of the asset or liability, but that it should not need to create quantitative information (eg an implied market multiple or future cash flows) to comply with the disclosure requirement if quantitative information other than the prior transaction price or third-party pricing information is not used when measuring fair value. However, the boards concluded that when using a prior transaction price or third-party pricing information, an entity cannot ignore other quantitative information that is reasonably available. If there was an adjustment to the price in a prior transaction or third-party pricing information that is significant to the fair value measurement in its entirety, that adjustment would be an unobservable input about which the entity would disclose quantitative information even if the entity does not disclose the unobservable information used when pricing the prior transaction or developing the third-party pricing information.

### *Level 3 reconciliation for recurring fair value measurements*

BC196 The exposure draft proposed requiring an entity to provide a reconciliation from the opening balances to the closing balances of fair value measurements categorised within Level 3 of the fair value hierarchy. IFRS 7 required such a disclosure for financial instruments after it was amended in March 2009 to introduce a three-level fair value hierarchy, and to require more detailed information about fair value measurements categorised within Level 3 of the fair value hierarchy. In addition, many IFRSs already required a similar reconciliation for all fair value measurements, not only for those that are categorised within Level 3 of the fair value hierarchy.

BC197 Some respondents agreed with the proposed reconciliation disclosure because they thought it would help meet the objective to provide meaningful information to users of financial statements about the relative subjectivity of fair value measurements. Other respondents thought that the disclosure requirement would be onerous and did not believe that the benefits would outweigh the costs, particularly for non-financial assets and liabilities. The IASB received similar feedback on the proposed amendments to IFRS 7. However, users of financial statements told the IASB that the disclosures made in accordance with US GAAP and IFRS 7 were helpful, particularly in the light of the global financial crisis that started in 2007. They indicated that the disclosures allowed them to make more informed judgements and to segregate the effects of fair value measurements that are inherently subjective, thereby enhancing their ability to assess the quality of an entity's reported earnings. Consequently, the IASB decided to require an entity to provide such a reconciliation.

BC198 The exposure draft and IFRS 7 did not distinguish between *realised* and *unrealised* gains or losses. That was because those documents referred to *gains or losses attributable to assets and liabilities held at the end of the reporting period*, which the IASB meant to be equivalent to *unrealised* gains or losses (ie realised gains or losses result from the sale, disposal or settlement of an asset or a liability, and therefore the asset or liability is no longer held by the entity at the reporting date, whereas unrealised gains or losses relate to changes in the fair value of an asset or a liability that is held by the entity at the reporting date). Respondents to the exposure draft wondered whether the different terminology used in the exposure draft and in Topic 820 meant that the disclosure proposed for IFRSs would be different from the disclosure required by US GAAP. To ensure that there would be no differences in interpretation of the requirements in IFRSs and US GAAP, the IASB decided to use the terms *realised* and *unrealised* in the reconciliation disclosure.

BC199 The IASB concluded that the disclosure should focus on recurring fair value measurements because it would be difficult to reconcile the opening balances to the closing balances for non-recurring fair value measurements when the carrying amount of an asset or a liability is not determined on the basis of fair value at each reporting period. For example, it would be difficult to reconcile changes in fair value when an asset held for sale is recognised at its carrying amount in accordance with IFRS 5 in one period and at fair value less costs to sell in the next period. The information gained from requiring a reconciliation of changes in fair value from one period to the next is not available when requiring changes resulting from the use of different measurement bases from one period to the next.

### *Valuation processes*

BC200 The boards decided to require an entity to disclose the valuation processes used for fair value measurements categorised within Level 3 of the fair value hierarchy (including, for example, how an entity decides its valuation policies and procedures and analyses changes in fair value measurements from period to period). They made that decision because users of financial statements told the boards that information about an entity's valuation processes helps them assess the relative subjectivity of the entity's fair value measurements, particularly for those categorised within Level 3 of the fair value hierarchy.

BC201 In addition, the requirements in IFRS 13 are consistent with the conclusions of the IASB's Fair Value Expert Advisory Panel as described in its report in October 2008.

### *Sensitivity to changes in unobservable inputs*

BC202 The exposure draft proposed requiring a quantitative sensitivity analysis for fair value measurements categorised within Level 3 of the fair value hierarchy. That proposal was taken from the requirement in IFRS 7 to disclose a sensitivity analysis if changing any of the unobservable inputs used in the measurement to reasonably possible alternative assumptions would change the fair value significantly. Although in IFRS 7 that disclosure was required for financial assets and financial liabilities measured at fair value, under the proposal it would have been required for all assets and liabilities measured at fair value.

BC203 In August 2009 the FASB proposed a similar disclosure requirement in its proposed ASU *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*, although that proposal would have required an entity to take into account the effect of interrelationships between inputs. Very few respondents to that proposed ASU supported the proposed disclosure, stating that it would not provide useful information and would be costly and operationally challenging. However, users were supportive of the proposed disclosure. The FASB decided to defer the consideration of a sensitivity analysis disclosure requirement to the joint fair value measurement project.

BC204 In the boards' discussions about that sensitivity analysis disclosure, they considered whether the IASB's proposed disclosure and that in IFRS 7 would be improved if the boards required an entity to include the effect of interrelationships between unobservable inputs, thereby showing a range of fair values (exit prices) that reasonably could have been measured in the circumstances as of the measurement date. Because that refinement of the disclosure was not included in the IASB's May 2009 exposure draft and was not required by IFRS 7, the IASB needed to expose the proposal to require the sensitivity analysis including the effect of interrelationships between unobservable inputs. That disclosure was referred to in the IASB's re-exposure document and the FASB's proposed ASU in June 2010 as a *measurement uncertainty analysis disclosure*.

BC205 Respondents to the FASB's proposed ASU and the IASB's re-exposure document were concerned about whether the proposal would be operational (those comments were consistent with those received on the FASB's proposed ASU in August 2009). Although that proposal was in response to requests from users of financial statements to require additional information about the measurement uncertainty inherent in fair value measurements (particularly those categorised within Level 3 of the fair value hierarchy), the responses from preparers of financial statements indicated that the costs associated with preparing such a disclosure would outweigh the benefits to users once the information had been aggregated by class of asset or liability. As an alternative to the proposal, those respondents suggested that the boards should require a qualitative assessment of the subjectivity of fair value measurements categorised within Level 3 of the fair value hierarchy, as well as an alternative quantitative approach that would be less costly to prepare (see paragraphs BC188–BC195).

BC206 Therefore, the boards decided to require an entity to provide a narrative description, by class of asset or liability, of the sensitivity of a recurring fair value measurement categorised within Level 3 of the fair value hierarchy to changes in the unobservable inputs used in the measurement if a change in those inputs to a different amount would result in a significantly higher or lower fair value measurement. If there are interrelationships between those inputs and other unobservable inputs, the boards decided to require an entity to provide a description of those interrelationships and of how they might magnify or mitigate the effect of changes in the unobservable inputs on the fair value measurement. The boards concluded that such information would provide users of financial statements with information about how the selection of unobservable inputs affects the valuation of a particular class of assets or liabilities. The boards expect that the narrative description will focus on the unobservable inputs for which quantitative information is disclosed because those are the unobservable inputs that the entity has determined are most significant to the fair value measurement. They will continue to assess whether a quantitative measurement uncertainty analysis disclosure would be practical after issuing IFRS 13, with the aim of reaching a conclusion about whether to require such a disclosure at a later date.

BC207 The boards concluded that a narrative description about sensitivity provides users of financial statements with information about the directional effect of a change in a significant unobservable input on a fair value measurement. That disclosure, coupled with quantitative information about the inputs used in fair value measurements categorised within Level 3 of the fair value hierarchy, provides information for users to assess whether the entity's views about individual inputs differed from their own and, if so, to decide how to incorporate the entity's fair value measurement in their decisions. In addition, that disclosure provides information about the pricing model for those users who are not familiar with the valuation of a particular class of assets or liabilities (eg complex financial instruments).

BC208 In addition to the narrative sensitivity analysis disclosure, IFRS 13 requires a quantitative sensitivity analysis for financial instruments that are measured at fair value and categorised within Level 3 of the fair value hierarchy (ie the disclosure that was previously in IFRS 7). The IASB decided to move that requirement from IFRS 7 to IFRS 13 so that all of the fair value measurement disclosure requirements in IFRSs are in a single location. When developing IFRS 7, the IASB concluded that information about the sensitivities of fair

value measurements to the main valuation assumptions would provide users of financial statements with a sense of the potential variability of the measurement. In forming that conclusion, the IASB considered the view that disclosure of sensitivities could be difficult, particularly when there are many assumptions to which the disclosure would apply and those assumptions are interdependent. However, the IASB noted that a detailed quantitative disclosure of sensitivity to all assumptions is not required (only those that could result in a significantly different estimate of fair value are required) and that the disclosure does not require the entity to reflect interdependencies between assumptions when making the disclosure.

BC209 The boards concluded that the objective of the narrative and quantitative sensitivity analysis disclosures about fair value are different from the objectives of other disclosures that an entity may be required to make in IFRSs and US GAAP, such as the market risk sensitivity analysis disclosure required by IFRS 7 (see paragraph 40 of IFRS 7). The IASB concluded that even though there is some overlap in those disclosures, the objective of each disclosure is different: the market risk sensitivity analysis disclosure in IFRS 7 provides information about an entity's exposure to future changes in market risks (ie currency risk, interest rate risk and other price risk), whereas the fair value measurement disclosures provide information about the sensitivity of the fair value measurement at the measurement date to changes in unobservable inputs for those fair value measurements with the greatest level of subjectivity (ie fair value measurements categorised within Level 3 of the fair value hierarchy). In addition, the market risk sensitivity analysis disclosure in IFRS 7 relates only to financial instruments (as does the quantitative sensitivity analysis disclosure in IFRS 13), whereas the narrative sensitivity analysis disclosure in IFRS 13 relates to all assets and liabilities measured at fair value.

BC210 The IASB identified the following differences between the market risk and fair value sensitivity analysis disclosures:

(a) The market risk disclosure is not specific to financial instruments measured at fair value, but also relates to financial instruments measured at amortised cost.

(b) The market risk disclosure focuses on the effect on profit or loss and equity, not specifically on the change in value.

(c) The market risk disclosure focuses only on the entity's exposure to market risks (ie interest rate risk, currency risk or other price risk), whereas the fair value disclosures take into account the effect on a fair value measurement of changes in significant unobservable inputs.

(d) The market risk disclosure does not distinguish between observable and unobservable inputs (or level in the fair value hierarchy, ie Level 1, 2 or 3), whereas the fair value disclosures relate only to the unobservable inputs used in fair value measurements categorised within Level 3 of the fair value hierarchy.