KPMG

Fair value measurement

Questions and answers

US GAAP and IFRS

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Contents

Comparability is the challenge

The use of fair value measurement for financial reporting continues on an upward trajectory and presents significant challenges, requiring judgment and interpretation.

Fair value measurement is not a static discipline and markets are demonstrating increasing interconnectedness and are inherently unstable. Further, the regulatory frameworks continue to change. This means that new valuation methodologies are being created and refined as they are adopted by market participants. And as the fair value standards dictate, it is the market participant view that shapes fair value.

As a result, preparers of financial statements cannot be complacent about the methodologies they use to measure fair value. Management needs to monitor developments in valuation techniques to ensure that its valuation models appropriately reflect the types of inputs that market participants would consider.

But monitoring alone isn't sufficient. Regulators frequently question preparers about many areas of fair value measurement, including the appropriateness of the assumptions used and disclosures. The European regulator, ESMA,[1] issued a report in July 2017[2] as part of the IASB's implementation review that discussed the application of IFRS 13, *Fair Value Measurement*. It found that the IFRS 13 requirements were well incorporated into the financial statements of the sampled issuers, but identified areas of improvement when applying IFRS 13. For example, the report called for more clarity in the standard in areas where there is uncertainty in practice. In addition, the report called for improvement in the level of compliance and comparability in applying IFRS 13.

Although the fair value accounting principles under US GAAP and IFRS are largely converged, achieving global comparability in measuring fair value is a continuous challenge in an ever-changing world.

We are pleased to help you navigate the complexity by providing our current guidance in this third edition of *Questions and Answers*.

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1. European Securities and Markets Authority.
2. Review of Fair Value Measurement in the IFRS financial statements.

About the standards

Chronology and objective

FASB ASC Topic 820, *Fair Value Measurement*, was originally issued in September 2006 as FASB Statement No. 157. The IFRS equivalent, IFRS 13, was issued in May 2011. At the same time, the FASB issued ASU 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in US GAAP and IFRSs*. The ASU amended US GAAP to achieve the Boards' objectives of a converged definition of fair value and substantially converged measurement and disclosure guidance.

Topic 820 and IFRS 13 define fair value, establish a framework for measuring fair value and a fair value hierarchy based on the source of the inputs used to estimate fair value, and require disclosures about fair value measurements. The standards do not establish new requirements for *when* fair value is required or permitted, but provide a single source of guidance on *how* fair value is measured. In general, this guidance is applied when fair value is required or permitted by other applicable GAAP.

Since our last edition of *Questions and Answers*, a disclosure simplification for investments measured using the net asset value per share practical expedient (or its equivalent) has become effective for public and nonpublic companies applying US GAAP (see section Q). The FASB also issued codification improvements that (1) amend the definition of readily determinable fair value (see Question Q15) and (2) clarify the difference between a valuation technique and a valuation approach (distinctions clarified throughout). Additionally, public and nonpublic companies may early adopt accounting standards that affect the guidance in Topic 820, which are highlighted as forthcoming requirements throughout (discussed in About this publication).

Summary of differences between US GAAP and IFRS

Throughout this publication, we highlight what we believe are significant differences between US GAAP and IFRS. However, many of these differences do not arise from the fair value measurement standards themselves, but because of the interaction of those standards with other US GAAP or IFRS requirements. For example, Question C90 discusses a key difference in respect of the unit of account; and Question I20 discusses day one gains or losses on the initial recognition of financial instruments.

The following summarizes what we believe are the few significant differences between US GAAP and IFRS caused by the fair value measurement standards.

US GAAP	IFRS
Disclosures (section N)	
Nonpublic entities are exempt from some requirements. In addition, certain qualifying nonpublic entities have additional exemptions for financial instruments.	Unlike US GAAP, there are no exemptions for nonpublic entities.
There is no requirement to disclose quantitative sensitivity information about Level 3 recurring measurements of financial instruments.	Unlike US GAAP, quantitative sensitivity information about Level 3 recurring measurements of financial instruments is required.
Practical expedient for investments in investment companies (section Q)	
There is a practical expedient to measure the fair value of these investments at net asset value if certain criteria are met.	Unlike US GAAP, there is no practical expedient for these investments.

About this publication

Purpose

The purpose of this publication is to assist you in understanding the requirements of, and the differences between, Topic 820, *Fair Value Measurement*, and IFRS 13, *Fair Value Measurement*.

Organization of the questions and answers

The questions and answers are numbered in steps of 10 so that future questions and answers can be added without breaking the flow of the commentary on fair value measurement. The questions and answers that have been added, deleted or substantially expanded in this edition are highlighted in the Appendix: Index of questions and answers.

Organization of the text

Each section of this publication includes a short overview, followed by questions and answers. Our commentary is referenced to the FASB ASC (or Codification) and to current IFRS literature, where applicable.

References to the relevant literature are included in the left-hand margin, with the IFRS references in square brackets below the US GAAP references. For example, *820-10-35-9* is paragraph 35-9 of Subtopic 820-10; and *IFRS 13.22* is paragraph 22 of IFRS 13.

The main text is written in the context of US GAAP. To the extent that the requirements of IFRS are the same, the references in the left-hand margin include both US GAAP and IFRS. However, if the requirements of IFRS are different from US GAAP, or a different wording might result in different interpretations in practice, a box at the end of that question and answer discusses the requirements of IFRS and how they differ from US GAAP.

Effective dates

New standards and interpretations issued by the IASB have a single effective date. In contrast, those issued by the FASB usually have at least two effective dates: one for public business entities, and one for other entities. This may be further nuanced by including certain other entities (e.g. employee benefit plans that file their financial statements with the SEC) with public business entities, and in some cases the effective date for public business entities is further split between SEC filers and non-SEC filers. This means that the effective date of a pronouncement can be spread over two or even three years. Appendix: Effective dates – US GAAP includes a table of effective dates to help navigate new requirements included in forthcoming requirements of this publication that are not yet (fully) effective.

Forthcoming requirements and future developments

When a currently effective requirement in Topic 820 or IFRS 13 is affected by a new standard or amendment that *changes* those requirements and has been issued at December 15, 2017, but is not yet effective, it is highlighted as a *forthcoming requirement*. Forthcoming requirements are noted for the following questions:

– US GAAP: B10, B40, B80, B90, C10, N70, O60 and O70.
– IFRS: B40, B80, B90, O50, O60 and O70.

When we anticipate a future change in Topic 820 or IFRS 13 as a result of a FASB or IASB project (i.e. no amendments have yet been made), this is highlighted as a *future development*. Future developments are noted for the following questions:

– US GAAP: K20.
– IFRS: C90, G100, L20 and L60.

These forthcoming requirements and future developments either are directly relevant to the application of Topic 820 or IFRS 13, or they are otherwise directly relevant to the specific question. They are not a complete listing of all forthcoming requirements and future developments under US GAAP and IFRS that deal with *when* a fair value measurement is required.

A. An introduction to fair value measurement

This section provides a brief introduction to some of the key terms used in fair value measurement, as well as a diagram that shows the flow of the publication in relation to the process of measuring fair value and determining the appropriate disclosures.

The key term that drives this process is *fair value*: the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is an *exit price* (e.g. the price to sell an asset rather than the price to buy that asset). An exit price embodies expectations about the future cash inflows and cash outflows associated with an asset or liability from the perspective of a *market participant* (i.e. based on buyers and sellers who have certain characteristics, such as being independent and knowledgeable about the asset or liability).

Fair value is a market-based measurement, rather than an entity-specific measurement, and is measured using assumptions that market participants would use in pricing the asset or liability, including assumptions about risk. As a result, an entity's intention to hold an asset or to settle or otherwise fulfill a liability is not relevant in measuring fair value.

Fair value is measured assuming a transaction in the *principal market* for the asset or liability (i.e. the market with the highest volume and level of activity). In the absence of a principal market, it is assumed that the transaction would occur in the *most advantageous market*. This is the market that would maximize the amount that would be received to sell an asset or minimize the amount that would be paid to transfer a liability, taking into account transaction and transportation costs. In either case, the entity needs to have access to that market, although it does not necessarily have to be able to transact in that market on the measurement date.

A fair value measurement is made up of one or more *inputs*, which are the assumptions that market participants would make in valuing the asset or liability. The most reliable evidence of fair value is a quoted price in an active market. When this is not available, entities use a valuation approach to measure fair value, maximizing the use of relevant observable inputs and minimizing the use of unobservable inputs.

These inputs also form the basis of the *fair value hierarchy*, which is used to categorize a fair value measurement (in its entirety) into one of three levels. This categorization is relevant for disclosure purposes. The disclosures about fair value measurements are extensive, with more disclosures being required for measurements in the lowest category (Level 3) of the hierarchy.

		Section
	Determine whether the item is in scope	B
Establish parameters:	Identify the item being measured	C
	Identify the unit of account and the unit of valuation	C
	Identify market participants, and identify the market	D, E
Select appropriate valuation approach(es) and technique(s):	Approach: market Example technique: quoted prices in an active market	F
	Approach: income Example technique: discounted cash flows	F
	Approach: cost Example technique: depreciated replacement cost	F
Determine inputs to measure fair value:	Level 1 Example: quoted price for an identical asset in an active market	G, H
	Level 2 Example: quoted price for a similar asset in an active market	G, H
	Level 3 Example: discounted cash flows	G, H
Measure fair value:	Fair value at initial recognition	I
	Highest and best use	J
	Liabilities and own equity instruments	K
	Portfolio measurement exception	L
	Inactive markets	M
	Disclose information about fair value measurements	N
	Application issues	O, P, Q

B. Scope

Overview

- Topic 820 provides guidance on how to measure fair value when such measurement is required by other Topics/Subtopics, and specifies the related disclosures to be made in the financial statements. Topic 820 does not mandate when a fair value measurement is required.
- Topic 820 applies to the following, subject to certain exceptions:
  - fair value measurements (both initial and subsequent) that are required or permitted by other Topics/Subtopics;
  - fair value measurements that are required or permitted to be disclosed by other Topics/Subtopics, but which are not included in the statement of financial position; and
  - measurements that are based on fair value, or disclosures of such measurements.
- The exceptions from the scope of Topic 820 include most share-based payment transactions, and leasing transactions.

B10. What are some examples of assets and liabilities that are measured at fair value based on Topic 820?

The following are some examples of assets and liabilities that fall within the scope of Topic 820 for the purpose of measurement and/or disclosure. The scope of the disclosure requirements, including the distinction between recurring and nonrecurring fair value measurements, is discussed in more detail in section N.

Topic 320, Topic 825

Topic 320

Topic 946

Topic	Measurement	Disclosure
Financial instruments available-for-sale or held for trading (recurring fair value measurements)	✓	✓
Financial instruments held-to-maturity subsequent to initial recognition	✗[3]	✓
Investments of investment companies	✓	✓

3. The measurement requirements of Topic 820/IFRS 13 do not apply to the measurement of financial instruments held-to-maturity in the statement of financial position subsequent to initial recognition because they are measured at amortized cost. However, Topic 820/IFRS 13 do apply to measuring fair value for disclosure purposes.