



Fair Value Hierarchy: A Deep Dive

Exploring current challenges and
complications in valuation

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01

Fair Value Hierarchy: Independent Observations



Fair Value Hierarchy: Independent Observations

How Do our Independent Levelling Classifications vary across key asset types.

1 Equities

96% Level 1

Many of our client's equity holdings are highly liquid and therefore typically fall under a Level 1 classification.

2 Listed Derivatives

51% Level 1

Listed derivatives are classified as Level 1 only approximately half of the time due to lower observed liquidity.

3 G7 Sovereign Debt

90% Level 1

Sovereign debt issued by G7 countries are primarily classified as Level 1 due to their high liquidity and active trading.

4 Other Sovereign Debt

53% Level 1

We note a significant reduction in Level 1 classifications for sovereign debt issued by other countries, characterised by wider bid/ask spreads.

5 Corporate Debt

34% Level 1

Only approximately one-third of corporate debt qualifies as Level 1 due to a lack of observable market prices.

96.55%

From a sample of one of KPMG's largest client's, we note **96.55%** of our **independent classifications** align with reporting entities across all asset types.

This **underscores the importance** of independent assessment and oversight in the fair value hierarchy classification process to **ensure compliance with IFRS 13**.

02

Fair Value Hierarchy: A Regulatory Perspective



Fair Value Hierarchy: A Regulatory Perspective

Key Considerations

How to determine an
"Active Market"

Are there quoted
prices available?

Are the inputs
observable or
unobservable?

How do we determine the
'significance' of our inputs?

Level 1

- Based on quoted prices in active markets.
- Reflect identical assets or liabilities.
- Require no valuation adjustments or modelling.
- Provide the most reliable evidence of fair value.

Illustrative Example

Level 1 Example: Listed Equity Security

- Shares of Apple Inc. traded on the NASDAQ.
- Price observed with high trading volume.

Why Level 1?

- **Quoted price** is directly observable from an active market (NASDAQ), requiring no adjustments or estimates.

Level 2

- Uses quoted prices from active or inactive markets for similar or identical assets or liabilities.
- Based on observable inputs, not primary active market data.
- Level 2 inputs use indirect market data, which may require adjustments and some estimation.

Illustrative Example

Level 2 Example: Corporate Bond

- A corporate bond issued by a small-sized company, which isn't traded frequently.
- There is quoted prices for similar bonds with comparable credit ratings and maturities.

Why Level 2?

- The bond isn't actively traded, but observable inputs like similar prices, yield curves, & credit spreads support its Level 2 classification.

Level 3

- Rely on internal models and assumptions.
- Incorporate entity-specific estimates and judgment.
- Subject to higher estimation uncertainty and sensitivity to inputs.

Illustrative Example

Level 3 Example: CLO Equity

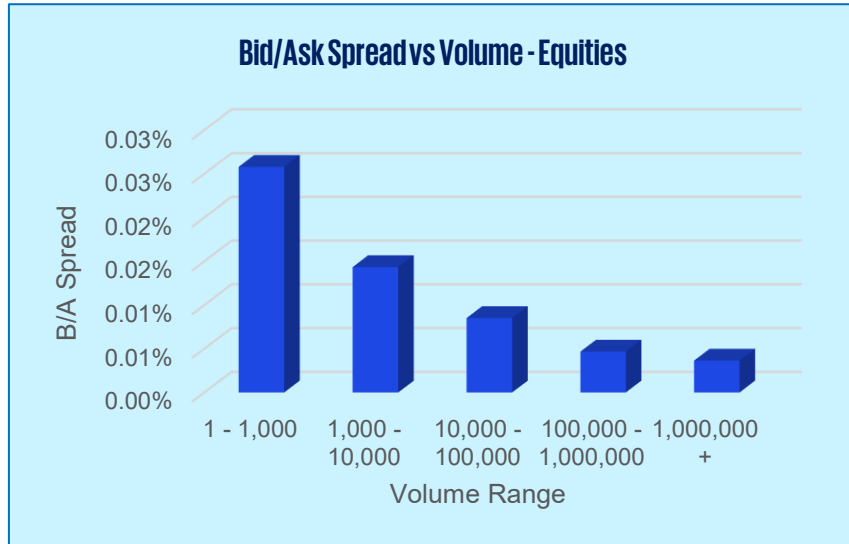
- Equity tranche of a Collateralised Loan Obligation (CLO).
- Estimated using a discounted cash flow (DCF) model incorporating assumptions about default rates, prepayment speeds, and recovery rates.

Why Level 3?

- No active market or observable prices.
- Inputs are significantly unobservable and based on assumptions.

Fair Value Hierarchy: A Regulatory Perspective

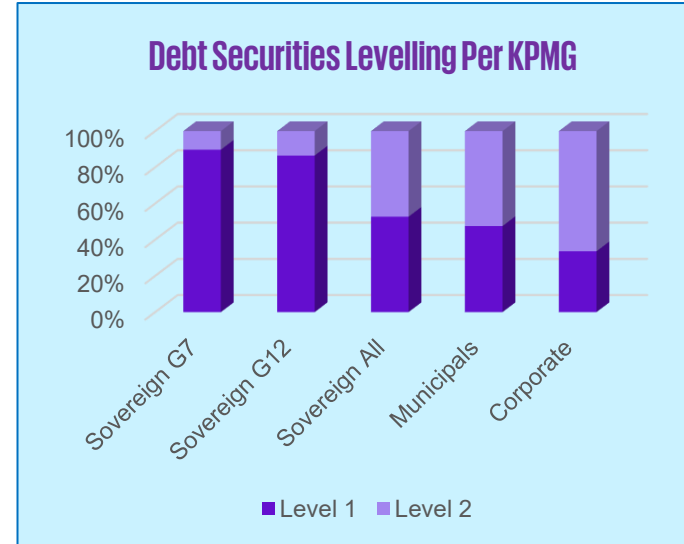
Bid/Ask Spread vs Volume - Equities



Equity Security Trends

- **Inverse Relationship Between Volume and B/A Spread:** We observe a clear inverse relationship between bid/ask spreads and trading volumes. This suggests that higher trading volumes are associated with better market liquidity and pricing efficiency.
- **Threshold Decisions:** This relationship guides the threshold decision making process and supports the idea that liquidity can serve as a strong indicator of reliability of pricing data.

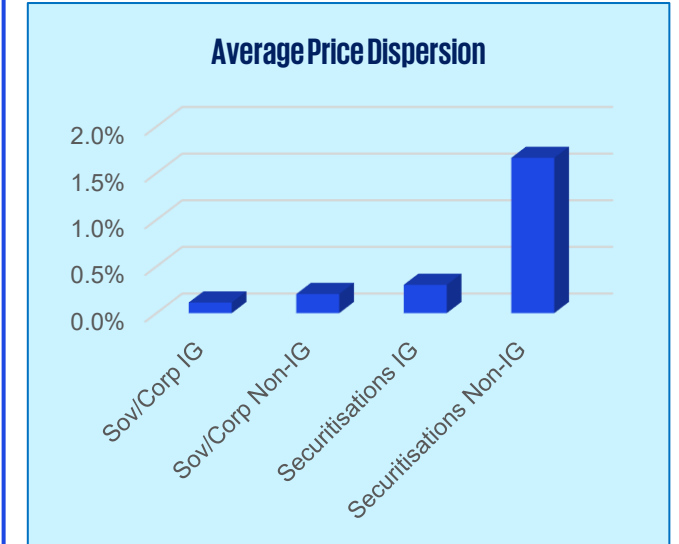
Independent FVH Classifications - Debt



FVH Debt Trends

- **Sovereign G7 and Sovereign G12** are predominantly classified as Level 1, indicating that these securities are traded in active markets with readily observable prices.
- **Municipal and Corporate bonds** show a much higher proportion in Level 2, suggesting that while market data exists, it is not as directly observable or as active as sovereign debt securities.

Vendor Price Dispersion - Debt



Debt Price Dispersion Trends

- **Securitised Non-IG** has the highest price dispersion, showing greater uncertainty or less consensus in valuation, which is characteristic of FVH Level 3 assets.
- **Corp/Sov IG** has the lowest dispersion, indicating more stable pricing. This aligns with FVH Level 1 or 2 characteristics, where market inputs are more observable and reliable.

03

Key Challenges and Our Insights on Levelling



What Constitutes an “Active” Market

“Active” Markets

Key Issue: Measurements of market activity can be different across entities or asset classes, or not even considered at all.

Subjectivity:

Determining what qualifies as an “active” market can vary by asset class, trading frequency, and transparency, requiring significant professional judgment. There is no definition of “active” in IFRS, and simply a quoted price is not sufficient to justify Level 1 classification.

Consistency:

Key indicators of market activity like trading volume, bid/ask spreads, and number of exchange listings lack universally accepted thresholds, which can make consistent classification difficult.

Example Scenario

An entity holds shares in a small-cap company listed on multiple exchanges and classifies them as Level 1 due to the availability of quoted prices on the measurement date.

Upon closer review:

- The stock trades only a couple of times per week, with low daily volume.
- The bid-ask spread is wide.
- The quoted price is based on limited trading activity, not a deep, liquid market.

Why This Is a Pitfall

- Classifying this price as Level 1 is not appropriate under IFRS 13, as it does not originate from an active market.
- The client may be unable to sell at the quoted price due to limited market activity.

KPMG’s Insight

Implementing policies and procedures that can help to justify an entity’s levelling is essential to ensure accuracy and consistency in levelling decisions.

Structured Framework

Implement a consistent framework combining quantitative thresholds (e.g. trading volume, bid/ask spreads) with qualitative factors like pricing source reliability and oversight.

Consistent Documentation

Ensure uniform application across asset classes and periods, supported by clear documentation that justifies classification decisions.

Ongoing Review and Adaptation

Regularly update thresholds and assumptions to reflect market changes, maintaining relevance and reducing misclassification risk.

Maximise Use of Level 1 Inputs

Use of Level 1 Inputs

Level 1 inputs should be prioritised but may not be the most readily available, particularly when dealing with securities with short maturities, like certain bonds and derivatives.

Misclassification of Level 1 as Level 2:

Firms may incorrectly classify actively traded securities as Level 2 by overlooking available Level 1 inputs.

Inconsistent Professional Judgment:

Firms may classify securities as Level 1 using professional judgment, but inconsistent or poorly documented rationale can lead to compliance risks.

Example Scenario

Firms often classify U.S. Treasury Bills as Level 2 by relying on evaluated prices from third-party services, rather than using directly observable prices in active markets.

Market Reality

- *U.S. Treasury Bills are among the most actively traded securities globally.*
- *They have readily available quoted prices in highly liquid and transparent markets.*

Although often classified as Level 2, U.S. Treasury Bills typically meet Level 1 criteria. Accurate classification supports transparent financial reporting.

KPMG's Insight

A structured approach to fair value classification and governance ensures consistency, transparency, and compliance with IFRS 13.

Family Approach

Clients often classify equities as Level 1 and bonds as Level 2 based on general traits, though instruments within the same family can involve inputs from different levels.

Consistent Fair Value Framework

Firms should implement a consistent fair value levelling framework with defined criteria, templates, and review processes to ensure transparency and justify Level 1 classifications.

Governance for Fair Value Compliance

Firms can enhance accountability and IFRS 13 compliance by establishing governance processes with periodic reviews, internal audits, and valuation committee sign-offs

Regulatory Scrutiny

Heightened Scrutiny

Increased regulatory oversight, IASB and FASB have intensified focus on fair value practices. Stricter expectations for how valuations are documented and justified.

Stricter Disclosure Standards

ASC 820 and IFRS 13 require:

- *Transparent input and methodology reporting.*
- *Greater detail in valuation disclosures.*

Demand for Defensible Levelling

Regulators expect clear, well-supported FVH classifications. This can be especially challenging for instruments with limited market data.

Example Scenario

Even for non-complex Level 2 securities, firms must meet SEC Rule 2a-5 requirements through thorough documentation, strong governance, and ongoing valuation oversight.

A large asset manager is valuing a portfolio of Level 2 fixed income securities, the firm must:

- *Document all assumptions and inputs used in the valuation model.*
- *Demonstrate oversight by the board or a designated valuation committee.*
- *Maintain records that support the fair value determination process.*

Even though the instruments are not complex, the firm must comply with SEC Rule 2a-5, which requires:

- *A robust governance framework.*
- *Ongoing monitoring of valuation risks.*
- *Clear policies and procedures for fair value determinations*

KPMG's Insight

Strong governance, clear documentation, and ongoing training are essential for fair value compliance, ensuring oversight, consistency, and alignment with IFRS 13 and ASC 820.

Governance and Oversight

Regulations require boards or valuation teams to oversee fair value processes, stay informed on updates, and be involved in key valuation decisions.

Enhance Documentation Practices

To meet regulatory expectations, firms should establish strong internal controls over FVH classification. This includes clear documentation, consistent policies, and regular internal reviews.

Informed Valuation Team

Ongoing training helps to ensure alignment with IFRS 13 and ASC 820, supporting both compliance and transparency in reporting.

Significance and Application of Level 3 Inputs

Significance

Entities often apply varying interpretations of what constitutes a “significant” Level 3 input. This can lead to inconsistent fair value hierarchy classifications.

Judgment on Input Significance

Use of a Level 3 input does not necessarily justify and overall Level 3 classification. The overall classification is the lowest significant level of input used.

Complex or Adjusted Inputs

Inputs such as internally derived discount rates or bespoke liquidity adjustments can obscure transparency and lead to misclassification between Level 2 and Level 3, particularly when their significance is not well understood.

Understanding Among Valuation Teams

On occasion, entities may lack the technical knowledge to properly assess and apply complex or unobservable inputs.

Example Scenario

To assess its impact on fair value classification, firms should follow a structured approach to evaluate the uncertainty and significance of historical volatility inputs.

Volatility is a key input in option valuation. While implied volatility is preferred, historical volatility is often used for illiquid positions as a proxy for future expectations. When this proxy involves significant estimation, it may be considered a Level 3 input, potentially leading to a Level 3 classification for the option depending on its impact on fair value.

	1-month	3-month	6-month	12-month
Volatility	10.45%	9.60%	9.51%	10.40%
Market Value	3,050	2,960	3,165	3,005

The significance this input has towards overall classification could be determined using the following steps:

- Calculate the uncertainty in the measure of historical volatility.
- Calculate the impact this has on the market value of the option.
- Determine whether this impact is significant.

KPMG's Insight

To support fair value classifications, firms should assess input significance with clear rules, document methods, and provide training and tools for consistent application.

Input Evaluation Framework

Firms should use clear thresholds and decision rules to assess input significance, supported by sensitivity analysis to quantify input impact and ensure consistent, defensible classifications.

Documentation and Review

Firms should document complex or adjusted inputs thoroughly, including rationale, data sources, and methods, with a review process to validate their relevance and valuation impact.

Training and Tools

Offer targeted training on input observability, significance, and FVH classification, supported by standard templates and guidance for consistent application.

Complex Valuation Models

Complex Valuation Models

Applying complex valuation models without full understanding can lead to misclassification of inputs, especially between Level 2 and Level 3, due to unclear assumptions and poor documentation.

Misunderstood Valuation Models

Complex valuation models are sometimes applied without being fully understood by firms. This lack of clarity increases the risk of misclassifying inputs between Level 2 and Level 3 in the fair value hierarchy, particularly when assumptions are not transparent or well-documented.

Example Scenario

Using unclear or overly simplistic valuation models can lead to misclassification of inputs, especially when unobservable data is mistakenly treated as observable, increasing the risk of fair value errors.

Lack of clarity and reliability in Models

For instance, when two counterparties enter into a derivative contract and independently value it, the use of simplistic or less reliable models can lead to classification errors - even if both valuations appear aligned.

If one counterparty uses an overly rudimentary model whose mechanics are not fully understood, it may rely on proxy or comparative data sources, potentially affecting the entity's fair value classification.

A general lack of understanding and clarity in such models can result in unobservable (Level 3) inputs being incorrectly classified as observable (Level 2), ultimately leading to misclassification.

KPMG's Insight

Effective valuation relies on clear documentation, independent validation, focused training, and well-supported bespoke models to ensure accurate fair value classification.

Documentation of models and inputs

Valuation models and assumptions should be documented to ensure transparency and auditability.

Conduct Independent Validations

Valuation models and results should be reviewed objectively to ensure accuracy and compliance.

Targeted training for valuation teams

Teams should be equipped with focused training to enhance their understanding of valuation techniques and regulatory expectations.

Bespoke models

The rationale and methodology must be clearly articulated to support credible and defensible FVH classification.

Robust Internal Policy

Internal Policy

Many firms lack clear FVH policies, leading to inconsistent classification and difficulty handling complex instruments, increasing compliance and audit risks.

Policy Clarity

Many firms lack detailed internal documentation for FVH classification, relying instead on broad policies that hinder consistent and accurate application.

Inconsistent application of FVH criteria

Without standardised procedures, teams may interpret levelling differently, especially in complex or borderline cases.

Classification Challenges

Ambiguous internal policies make it hard to classify complex instruments accurately, increasing non-compliance risks and weakening transparency and reporting integrity.

Example Scenario

A firm classifies a lightly traded corporate bond as Level 2 based on pricing vendor data.

Inconsistent Classification Practices

The absence of detailed internal policies prevents teams from properly evaluating input observability or market activity, leading to inconsistent treatment – such as one team member classifying a bond as Level 1 using a less conservative approach, while another team member classifies the same bond as Level 2.

Disclosure Risks

Inconsistent classification and weak documentation increase reliance on subjective judgment, undermining the comparability and defensibility of fair value disclosures and potentially triggering concerns during audits or regulatory reviews.

KPMG's Insight

To support consistent FVH classification, firms should set clear policies, embed regulatory standards in governance, and provide ongoing training as requirements evolve.

Develop standardised FVH policies

Clearly define levelling criteria and use visual tools like decision trees to ensure consistent application across teams and asset types.

Strengthening Governance

Enhance compliance and objectivity, firms should embed IFRS 13 and ASC 820 requirements directly into internal procedures and conduct independent reviews of classification policies and their application.

Provide regular training and updates

This will allow valuation teams to maintain understanding and consistency as standards evolve.

04

Enhancing Levelling Accuracy: KPMG Guarantees



Enhancing Levelling Accuracy: KPMG Guarantees



Independent Fair Value Hierarchy Assessments:

KPMG leverages its valuation expertise to provide independent fair value hierarchy classifications, assessing factors such as trade volume and bid-ask spreads to evaluate market activity and liquidity.



Review of Valuation Methodologies:

KPMG conducts in-depth reviews of valuation approaches to identify gaps or inconsistencies with IFRS 13 and industry best practices.



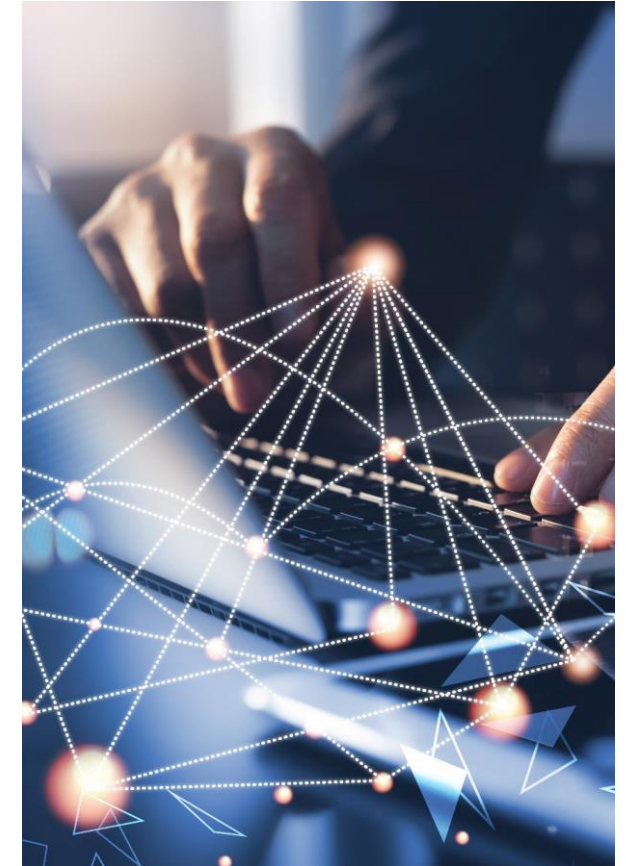
Ongoing Monitoring and Regulatory Alignment:

KPMG tracks changes in asset characteristics, market conditions, and reporting standards to ensure valuations remain current and compliant.



Data-Driven Pricing and Process Enhancement:

KPMG leverages proprietary and third-party data to improve pricing accuracy and offers actionable recommendations to firms to refine FVH processes.



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