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Chapter 9

How do I measure and report fair value information?

A white rounded rectangular button with the text "View full handbook" in black. The button is positioned in the bottom left corner of the page.

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A decorative graphic consisting of several bright green circles of varying sizes and a thick, light blue line that starts from the right side and extends towards the bottom right corner. The circles and line are overlaid on the background image of a modern building.

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What is fair value?

ASC 820 sets forth guidance on how to determine the fair value measurement of assets and liabilities—including interests in securitizations (e.g., securitization certificates, interest-only (IO) strips, underlying collateral)—and also outlines the disclosures that must accompany fair value measurements. Before diving into the details, it is important to note one thing: ASC 820 does not prescribe when fair value is required; rather, it creates a uniform definition for determining fair value under GAAP—using an “exit price” notion—when other areas of GAAP require fair value to be measured either for financial statement or footnote disclosure purposes. ASC 820 also makes clear that fair value is a market-based, not an entity-specific, measurement. ASC 820’s three-level fair value measurement hierarchy, described below, strives to bring increased transparency, consistency, and comparability to fair value estimates.

Consistency and comparability are clearly desirable in financial reporting; however, ASC 820’s goals are squarely at odds with the wide range of valuation techniques used to value securitization interests. The friction between the numerous valuation practices and ASC 820’s desire for consistency and comparability is at the core of fair value controversies. However, no matter how complicated or detailed the technique or methodology, the end goal for accounting purposes remains the same: to derive an estimate of the price at which assets may be sold or liabilities may be transferred in the market at the valuation date under current market conditions.

Do I need to measure the fair value of each position individually or can I use a portfolio approach?

Generally, ASC 820 views an individual security as the appropriate unit of valuation for financial instruments. For example, the fair value of a large holding of a particular security would generally be determined as the product of the price per unit (e.g., per share or dollars of par value) times the quantity of units held. In fact, using “blockage” factors is specifically prohibited.

That said, ASC 820 does permit an entity to make an accounting policy choice to measure the fair value of a specific group of financial assets and financial liabilities on the basis of what would be received to exit a net-long or net-short position if all of the following conditions are met:

- The entity manages the group of assets and liabilities on the basis of its net exposure to either market risks (e.g., interest rate risk, currency risk, or other price risk) or credit risk.
- The entity provides information about the group on a net basis to management.
- All of the financial assets and liabilities are measured at fair value in the balance sheet (either by requirement or through election of the fair value option).



While the fair value measurement may be performed on a net basis, the presentation of those financial assets and financial liabilities would still be reported on a gross basis unless they meet the offsetting criteria in ASC 210, *Balance Sheet*. Therefore, even if an entity avails itself of the portfolio-based fair value practical expedient, it will have to use judgment to develop a reasonable and consistent methodology to attribute the portfolio fair value measurement to the individual financial assets and financial liabilities that constitute the group for presentation in the financial statements.

1, 2, 3: What level to be?

The three-level fair value hierarchy exists to communicate the reliability of the inputs used to estimate fair value and requires entities to prioritize the use of observable inputs. That is, when estimating fair value, entities are required to maximize the use of relevant observable inputs using the following hierarchy:

Level 1: Quoted prices for the identical asset in an active market, without adjustment.

Level 2: Anything that is not Level 1 but is directly or indirectly observable, including:

- Quoted prices for similar assets or liabilities in active or inactive markets.
- Inputs other than quoted prices that are observable, such as yield curves.
- Inputs derived principally from, or corroborated by, observable market data.

Level 3: Unobservable inputs that reflect the reporting entity's own assessment about the assumptions market participants would use to estimate fair value, including assumptions about risk.

One approach for estimating the fair value of beneficial interests issued in a securitization is a three-step present-value technique that:

- Creates the best estimate of cash flows generated from the underlying assets;
- Applies the asset cash flows to the cash outflows per the transaction documents (i.e., the waterfall); and
- Discounts the cash flows for the securities held at the yield a buyer will demand.

Is the market always right? What if it dries up?

An investor will look to the markets to obtain observable information to be utilized in the fair value estimation process. But before arriving at the inputs for the valuation technique above, investors must evaluate the market so they can make the appropriate judgments about the information being conveyed through various pricing signals.

If an investor reaches a conclusion that there has been a significant decline in the volume or activity in a given market, further analysis of the transactions or quoted prices is needed, and an adjustment to the transactions or quoted prices, or a change in the valuation methodology employed, may be necessary to estimate fair value. Adjustments also may be necessary in other circumstances (e.g., if a price for a similar asset requires adjustment to make it more comparable to the asset being measured or when the price is stale).

To determine that a decrease in volume or level of activity has occurred, the investor needs to evaluate the following factors that are indicative of illiquid markets:

- There are few recent transactions.
- Price quotations are not based on current information.
- Price quotations vary substantially either over time or among market makers (e.g., some brokered markets).
- Indices that previously were highly correlated with the fair values of the asset or liability are demonstrably uncorrelated with recent indications of fair value for that asset or liability.
- There is a significant increase in implied liquidity risk premiums, yields, or performance indicators (such as delinquency rates or loss severities) for observed transactions or quoted prices when compared with the reporting entity's estimate of expected cash flows, considering all available market data about credit and other non-performance risk for the asset or liability.
- There is a wide bid-ask spread or significant increase in the bid-ask spread.

- There is a significant decline or absence of a market for new issuances for the asset or liability or similar assets or liabilities.
- Little information is publicly available (e.g., a principal-to-principal market).

Together, an investor's observations of information in the market and judgments about the conditions of the market will drive the ultimate estimate of inputs into the present-value technique described above.

What is the best estimate of cash flows? How do I know whether my model of the structure is correct? What yield should I use to discount the cash flows?

As is usually the case, the answer to these questions is, "it depends." As a general rule, however, investors must answer these questions based on what a market participant would use and not based on their own view. Investors need not undertake exhaustive efforts to obtain information about market participant assumptions, but they need to incorporate information that is reasonably available without undue cost and effort.

The continuing proliferation of detailed information on asset pools underlying securitizations results in an environment where the amount of information that might be considered in estimating the asset cash flows is often overwhelming. Consequently, there are sophisticated forecasting models that take into account a variety of factors—such as regional unemployment, home price appreciation or depreciation, the length of time a court will take to liquidate a property in bankruptcy, and the degree to which loan modification programs will take hold—in an effort to arrive at a forecast of securitization collateral cash flows to be applied to the structure.

Further complicating the situation, some structures incorporate bespoke or custom features that are difficult to model and may be highly subjective. In certain cases, these features are major drivers of value, potentially rendering the first step of the process (asset cash flow estimation) incredibly difficult. For example, many of the "event of default" and subordination provisions in collateralized debt obligations challenge investors to conclude on interpretations of waterfalls described within transaction documents, often with very little or no precedent.

Once an investor has the appropriate inputs to make an estimate of the asset cash flows, and those cash flows are applied to the structure through an accurate model, the investor needs to determine the appropriate rate of return that a market participant would demand should some or any of the beneficial interests be sold.

To that end, ASC 820 provides a useful example of one technique a market participant might use to arrive at a market rate of return for an RMBS. In this example, a market participant begins with an observable risk-free rate, and then makes adjustments by adding or subtracting basis points for product type, length of time outstanding, market conditions at inception versus the valuation date, credit risk, liquidity risk, and other factors. The result is an estimate of a market rate of return that incorporates and quantifies adjustments based on other observable and unobservable factors. The example also highlights one way to incorporate the difference between the cash nature of the asset and the synthetic nature of an index, as well as the difference between assets backing the security and those backing the index. Many of the adjustments are tied to concepts that highlight indicators for when a market has seen a decline in volume or activity.

Do I need to mark my book to indices?

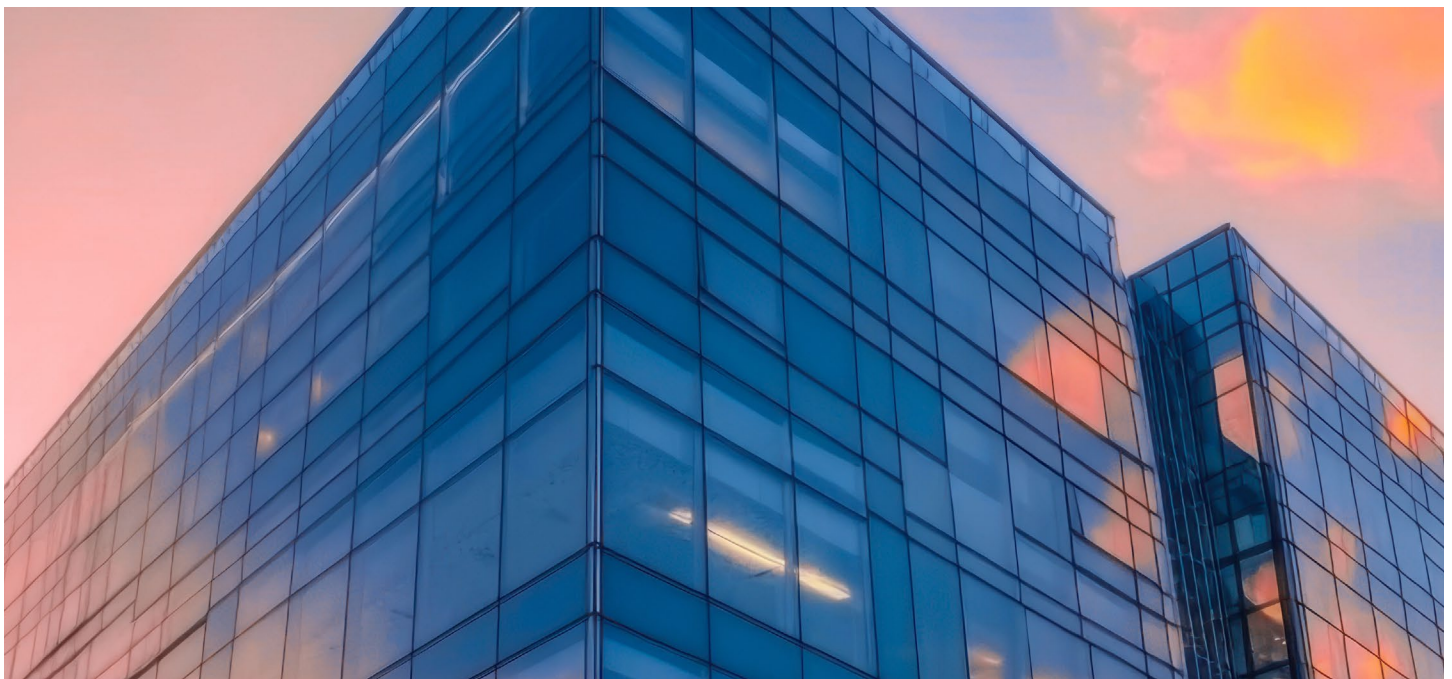
The creation of indices to track prices for securities at different levels of the capital stack for different products issued in certain vintages provides ever-increasing flexibility to investors in terms of hedging capabilities, speculation, and price discovery. Unfortunately, the indices only directly translate to fair value for the exact same portfolio of securities; consequently, adjustments are required in order to determine the fair value of a single security. Ultimately, one needs to determine whether the adjustments that must be made to indices in order to arrive at a market rate of return result in a more reliable estimate than the return one would estimate using another less observable, but perhaps more relevant, input.

Can I book a gain or loss at inception? How do I calibrate my models?

To the extent sale accounting is achieved, gains or losses from a securitization will arise for the seller when the fair value of the proceeds and potential recognition of servicing assets or liabilities from the transaction is greater or less than the carrying amount of the assets and/or liabilities transferred. If the seller receives any beneficial interests in the transferred assets, care must be exercised in the estimation of fair value for those interests.

The determination of fair value for securitization interests must adhere to the exit price notion called for in ASC 820, which recognizes the potential for the transaction price to be different from the exit price. Many in the securitization community interpret parts of ASC 820 to support an attack on the use of “mark to model” for received beneficial interests, or newly acquired investments, because the fair value established through the use of a model might result in higher estimates of exit price than would a negotiated transaction price.

In a speech in 2006, the SEC staff made it clear that models used to estimate fair value must be calibrated to reflect market conditions on the transaction date in a way that results in the exit price equaling transaction price, absent circumstances where the transaction price does not reflect fair value.¹ Transaction price might not reflect fair value when the transaction is between related parties, when the seller is transacting under duress, or when the transaction price is established in a market that is not the reporting entity’s principal or most advantageous market.



¹ Speech by SEC Staff: Remarks Before the 2006 AICPA National Conference on Current SEC and PCAOB Developments by Joseph D. McGrath, December 11, 2006, <https://www.sec.gov/news/speech/2006/spch121106jdm.htm>.

What if I need to change valuation methods? What other information about fair value estimates should I disclose?

Changes in valuation techniques or the application thereof could arise for many reasons. Techniques can be refined, or become less effective than alternatives, and markets could develop, consequently providing greater insight and stronger pricing signals, or they could diminish, leaving a dearth of pricing information.

When changes occur, diligent consideration of the significance of valuation inputs must be given in order to appropriately classify the estimate in the fair value hierarchy. In accounting parlance, the change in valuation technique or its application is typically accounted for as a change in accounting estimate under ASC 250, *Accounting Changes and Error Corrections*. While ASC 250 has its own disclosure requirements, those criteria are not applicable because of existing fair value disclosures under ASC 820 that require disclosure of changes in valuation techniques. In any interim or annual period, reporting entities must discuss the valuation techniques used to measure fair value, as well as any changes in the techniques and inputs used for each major security type. Examples of major security types could include:

- Equity securities (segregated by industry type, company size, or investment objective)
- Debt securities issued by the US Treasury and other US government corporations and agencies
- Debt securities issued by US states or municipalities
- Debt securities issued by foreign governments
- Corporate debt securities
- RMBS
- CMBS
- CLOs
- Other debt obligations

How do I measure the fair value of financial assets and financial liabilities of a collateralized financing entity I am required to consolidate?

The fair value of the financial assets of a collateralized financing entity may differ from the fair value of its financial liabilities even when the financial liabilities have recourse only to the financial assets. ASC 810 provides a measurement alternative such that the reporting entity should measure both the financial assets and financial liabilities of that consolidated financing entity in its consolidated financial statements using the more observable of the fair value of the financial assets and the fair value of the financial liabilities as follows:

- If the fair value of the financial assets of the collateralized financing entity is more observable, those financial assets should be measured at fair value, and the financial liabilities should be measured in consolidation as: (1) the sum of the fair value of the financial assets and the carrying value of any nonfinancial assets held temporarily, less (2) the sum of the fair value of any beneficial interests retained by the reporting entity (other than those that represent compensation for services) and the reporting entity's carrying value of any beneficial interests that represent compensation for services. The resulting amount should be allocated to the individual financial liabilities (other than the beneficial interests retained by the reporting entity) using a reasonable and consistent methodology.
- If the fair value of the financial liabilities of the collateralized financing entity is more observable, those financial liabilities should be measured at fair value, and the financial assets should be measured in consolidation as: (1) the sum of the fair value of the financial liabilities (other than the beneficial interests retained by the reporting entity), the fair value of any beneficial interests retained by the reporting entity (other than those that represent compensation for services), and the reporting entity's carrying value of any beneficial interests that represent compensation for services, less (2) the carrying value of any nonfinancial assets held temporarily. The resulting amount should be allocated to the individual financial assets using a reasonable and consistent methodology.



That guidance also clarifies that when this measurement alternative is elected, a reporting entity's consolidated net income (loss) should reflect the reporting entity's own economic interests in the collateralized financing entity, including: (1) changes in the fair value of the beneficial interests retained by the reporting entity and (2) beneficial interests that represent compensation for services. Note that beneficial interests retained by the reporting entity that represent compensation for services (e.g., management fees or servicing fees) and nonfinancial assets that are held temporarily by a collateralized financing entity should be measured in accordance with other applicable topics.

When the measurement alternative is not elected for a consolidated collateralized financing entity, (1) the fair value of the financial assets and the fair value of the financial liabilities of the consolidated collateralized financing entity should be measured using the requirements of ASC 820, and (2) any differences in the fair value of the financial assets and the fair value of the financial liabilities of that consolidated collateralized financing entity should be reflected in earnings and attributed to the reporting entity in the consolidated statement of income (loss).

What are the disclosure requirements?

There are a number of disclosures required by entities that report financial assets at fair value on a recurring basis. Among others, these include:

- a) The fair value measurements at the reporting date.
- b) The level within the fair value hierarchy in which the fair value measurements in their entirety fall, segregating fair value measurements using quoted prices in active markets for identical assets or liabilities (Level 1), significant other observable inputs (Level 2), and significant unobservable inputs (Level 3).
- c) For Level 2 and Level 3 fair value measurements, a description of the valuation techniques and inputs used in determining fair value. If there has been a change in either or both a valuation approach and a valuation technique, a description of the change and reason for making it.
- d) For fair value measurements categorized within Level 3, quantitative information about the significant unobservable inputs used in the fair value measurement. The range and weighted average of significant unobservable inputs should be provided, including how weighted average is calculated.
- e) For fair value measurements using significant unobservable inputs (Level 3), a reconciliation of the beginning and ending balances, separately presenting changes during the period attributable to the following:
 - (1) Total gains or losses for the period (realized and unrealized), segregating those gains or losses included in earnings (or changes in net assets), and a description of where those gains or losses included in earnings (or changes in net assets) are reported in the statement of income (or activities).
 - (2) Total gains or losses for the period recognized in other comprehensive income, and the line item(s) in other comprehensive income in which those gains or losses are recognized.
 - (3) Purchases, sales, issuances, and settlements (each presented separately).
 - (4) Transfers in and/or out of Level 3 (e.g., transfers due to changes in the observability of significant inputs) and the reasons for those transfers. Transfers into Level 3 should be disclosed and discussed separately from transfers out of Level 3.
- f) For recurring fair value measurements categorized within Level 3, a narrative description of the uncertainty of the fair value measurement from the use of significant unobservable inputs if those inputs reasonably could have been different at the reporting date. For example, how a change in those significant unobservable inputs to a different amount might result in a significantly higher or lower fair value measurement at the reporting date.
- g) For recurring fair value measurements categorized within Level 3, the amount of the total gains or losses for the period in subparagraph (e)(1) above included in earnings (or changes in net assets) and in subparagraph (e)(2) above included in other comprehensive income that are attributable to the change in unrealized gains or losses relating to those assets and liabilities still held at the reporting date and a description of where those unrealized gains or losses are reported in the statements of comprehensive income (or activities).
- h) If the reporting entity elects the measurement alternative for consolidated collateralized financing entities, for the less observable of the fair value of the financial assets and the fair value of the financial liabilities, it shall disclose that the amount was measured on the basis of the more observable of the fair value of the financial liabilities and the fair value of the financial assets for those financial assets and financial liabilities that are not incidental to the operations of the collateralized financing entity and have carrying values that approximate fair value (e.g., cash, broker receivables, or broker payables).
- i) For nonpublic entities, in lieu of item e above: (1) the purchases and issues (each of those types of changes disclosed separately) and (2) the amounts of any transfers into or out of Level 3 of the fair value hierarchy and the reasons for those transfers with transfers into Level 3 separately disclosed and discussed from transfers out of Level 3.

How does international accounting compare?

IFRS 13, *Fair Value Measurement* governs fair value measurements and the related disclosure requirements. IFRS is substantially converged with GAAP. That is, a fair value measurement under IFRS should be essentially the same as a fair value measurement determined under GAAP. That said, some of the more notable differences between IFRS 13 and ASC 820 are listed here.

Subject	GAAP	IFRS
Practical expedient: Net asset value	<p>An entity may measure its investment in entities that do not have readily determinable fair values and meet the definition of an investment company under ASC 946, <i>Financial Services - Investment Companies</i>, at net asset value as a practical expedient.</p>	<p>IFRS does not have this practical expedient.</p>
Initial recognition: Day 1 gains and losses	<p>GAAP does not prohibit the immediate (or Day 1) recognition of differences between initial fair value and transaction price, including differences that arise when unobservable inputs are used in the initial fair value measurement.</p>	<p>Under IFRS, an entity is prohibited from immediately recognizing gains and losses related to unobservable inputs.</p>
Disclosure: Offsetting fair value measurements disclosed in Level 3 roll-forward	<p>ASC 820 permits entities to present derivative assets and liabilities on either a gross or a net basis in the reconciliation disclosure.</p>	<p>IFRS generally does not permit net presentation for derivatives.</p>
Disclosure: Sensitivity analysis	<p>ASC 820 requires a narrative description of the uncertainty in recurring Level 3 measurements from the use of significant unobservable inputs if those inputs reasonably could have been different at the reporting date. Quantitative sensitivity analysis is not required.</p>	<p>IFRS 13 requires quantitative information about significant changes in recurring Level 3 measurements resulting from changes in one or more unobservable inputs to reflect reasonably possible alternative assumptions, including the amount of the change in inputs, the amount of the change in the measurement, and how the effect was calculated.</p>
Disclosure: Exemptions available to nonpublic entities	<p>Nonpublic entities are exempt from these disclosure requirements under ASC 820:</p> <ul style="list-style-type: none"> • Narrative description of the uncertainty in recurring Level 3 measurements from the use of significant unobservable inputs if those inputs reasonably could have been different at the reporting date. • For recurring fair value measurements categorized within Level 3, the amount of the total gains or losses for the period included in earnings (or changes in net assets) and included in other comprehensive income that are attributable to the change in unrealized gains or losses relating to those assets and liabilities still held at the reporting date and a description of where those unrealized gains or losses are reported in the statements of comprehensive income (or activities). • The range and weighted average of significant unobservable inputs used to develop Level 3 fair value measurements. 	<p>Nonpublic entities are not exempt from any of the disclosure requirements in IFRS 13.</p>
Measurement alternative for consolidated collateralized financing entities	<p>GAAP provides a measurement alternative such that the reporting entity should measure both the financial assets and financial liabilities of that consolidated financing entity in its consolidated financial statements using the more observable of the fair value of the financial assets and the fair value of the financial liabilities.</p>	<p>IFRS does not contain any guidance specific to the measurement of consolidated collateralized financing entities.</p>

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