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Insights into GASB Investments Guidance

Statements 31, 40, 72, and 79

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The views expressed in this presentation are those of Mr. Galloway.
Official positions of the GASB are reached only after extensive due process and deliberations.

Highlights of Statement 72

- Statement provides further guidance on fair value measurements
 - Basis is FASB Topic 820, “Fair Value Measurement”
- Scope is not limited to investments
 - Certain assets and liabilities measured at fair value
 - Includes derivatives
- Covers measurement, application, and disclosure
- Objective of the Statement
 - Increased comparability between governments, greater accountability, and a better measure of the resources available to governments

Part I: Fair Value Measurement

- Definition of 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.
 - Apply to assets and liabilities
 - An exit price
- Other characteristics of fair value measurement
 - Market-based
 - Based on a government's principal or most advantageous market

Fair value measurement (continued)

□ Unit of Account

- Stand-alone asset or liability or a group of assets or liabilities
- Determined by the standard that requires fair value measurement
- Refers to the level at which assets and liabilities are aggregated or disaggregated

Unit of Account: Implementation Question

- Scenario:
 - A government holds an investment in a limited partnership.
 - The partnership has investments in various countries.
- **Question:** Should the government “look through” to the partnership’s investments to identify its foreign currency risk disclosures?
- **Answer:** No. The unit of account of the government’s investment is not the underlying assets held by the partnership, rather, it is the government’s ownership interest in the partnership.

Fair value measurement (continued)

- **Market participants**
 - Fair value measurement determined using the assumptions market participants would use in pricing the asset or liability
- **Price**
 - Not adjusted for transaction costs
- **When market information is not available**
 - Estimate the price at which an orderly transaction would take place between market participants at that date (for example, a valuation technique)

Fair value measurement (continued)

- **Nonfinancial assets at fair value**
 - Value at the asset's highest and best use
 - A government's current use is presumed to be the highest and best use, unless otherwise suggested
 - May be in combination with other assets and liabilities or on a stand-alone basis

- **Liabilities at fair value**
 - For example: derivative liabilities (no fair value option)
 - Take government's credit standing into account
 - If there is no active market:
 - Consider liabilities held by other parties as assets
 - If the above is unavailable, use a relevant valuation technique

Fair value measurement (continued)

- Valuation Techniques: Apply valuation technique(s) that best represent(s) fair value in the circumstances
 - Market approach—based on market transactions
 - Cost approach—cost to replace present service capacity
 - Income approach—discounted present values
- Fair Value Hierarchy
 - **Level 1:** quoted prices (unadjusted) in active markets for identical assets or liabilities, most reliable
 - **Level 2:** quoted prices for similar assets or liabilities, quoted prices for identical or similar assets or liabilities in markets that are not active, or other than quoted prices that are observable
 - **Level 3:** unobservable inputs, least reliable

Valuation Technique and Fair Value Hierarchy: Implementation Question

- Scenario: A government holds an investment in a mutual fund.
- **Question:** Where is this investment placed in the fair value hierarchy?
- **Answer:** Generally, the fair value hierarchy of mutual funds is determined using the market approach that is classified as a Level 1 input. Therefore, it is likely to qualify as a Level 1 fair value.

Fair Value Hierarchy: Implementation Question

- Scenario: A government has an investment position in an external investment pool.
- **Question:** Where should the government's investment position be categorized within the fair value hierarchy?
- **Answer:**
 - If the pool elects to comply with Statement 79 and measures its investments at amortized cost, the government's position in that pool also should be measured at amortized cost and therefore, it should not be categorized within fair value hierarchy.
 - If the pool measures its investments at fair value, the government's position in that pool are not required to be categorized within the fair value hierarchy

Fair value measurement (continued)

- Additional measurement guidance for:
 - Adjustments of observable inputs
 - Measuring fair value when volume or level of activity has significantly decreased
 - Transactions that are not orderly

Fair value measurement (continued)

- Measuring fair value of investments in certain entities that calculate net asset value (NAV) per share (or its equivalent)
 - NAV per share may be used as a practical expedient to estimate fair value
 - Adjustment to NAV per share amount may be necessary to be consistent with measurement principles
 - May be applied on an investment-by-investment basis but must be applied consistently to fair value measurement of the government's entire position in a particular investment
 - If sale of a portion of an investment at an amount different from net asset value per share is probable, the practical expedient may not be applied

PART II. Fair Value Application

- Definition of an investment
 - A security or other asset that a government holds **primarily** for the purpose of income or profit and
 - With a present service capacity that is based **solely** on its ability to generate cash or to be sold to generate cash

- Key notions
 - Held primarily for income or profit
 - Acquired first and foremost for future income and profit
 - Purpose determined by a government at acquisition
 - Classification remains even if usage changes

Fair value application (continued)

- Measured at fair value
 - Assets and liabilities that meet the definition of an investment generally should be measured at fair value

- Examples, if they meet the definition of an investment
 - Intangible assets
 - Land and land rights
 - Real estate
 - Lending assets
 - Natural resource assets

Definition of an Investment: Implementation Question

- Scenarios

1. In FY 2008 a school district purchased land for its operation and classified the land as a capital asset. Starting January 2017, the school district decided that the land is to be held for income rather than for its own operations.
2. In FY 2008 a pension plan purchased a building to be held for income and classified the building as an investment. Starting in January 2017, the pension plan decided to use the building for its own administration rather than using it for income.

Definition of an Investment: Implementation Question

- **Question**

- In each scenario, can management reclassify the assets?

- **Answer**

- No, to both scenarios.

Fair value application (continued)

- Additional investment-types that would be measured at fair value
 - Investments that are already measured at fair value (including securitized mortgages)
 - Alternative investments
 - Equity securities (including unit investment trusts and closed-end mutual funds), stock warrants, and stock rights that do not have readily determinable fair values
 - Provided such investment-types are not reported according to the equity method
 - Co-mingled investment pools that are not government sponsored
 - Invested securities lending collateral

Fair value application (continued)

- Investments excluded from scope and not fair valued
 - Money market investments and participating interest-earning investment contracts that have a remaining maturity at time of purchase of one year or less, reported by governments other than external investment pools
 - Investments held by external investment pools that elect amortized cost per Statement 79
 - Investments in life insurance. Investments in life settlement contracts, however, should be at fair value
 - Investments in common stock that meet the criteria for applying the equity method
 - Investments in common stock held by endowments as well as investments in certain entities that calculate net asset value per share are ineligible for the equity method.
 - Non-participating interest earning investment contracts
 - Unallocated insurance contracts
 - Synthetic guaranteed investment contracts that are fully benefit responsive

Fair value application (continued)

- Acquisition value (an entry price) replaces fair value for the following:
 - Donated capital assets
 - Donated works of art, historical treasures, and similar assets
 - Capital assets received through a service concession arrangement

Fair value application (continued)

- Investment income

- All investment income, including changes in the fair value of investments, should be recognized as revenue in the flows statement
- Change in fair value should be captioned “net increase (decrease) in the fair value of investments”
- Realized gains and losses and net increase (decrease) in fair value of investments should not be displayed separately in the financial statements
 - Exception: realized gains and losses may be displayed separately in the reports of governmental external investment pools

Fair Value Note Disclosures

- Organized by type or class of asset or liability based on considerations including the following:
 - The nature, characteristics, and risks of the asset or liability
 - The level of the fair value hierarchy within which the fair value measurement is categorized
 - Whether Statement 72 or another Statement specifies a type or class for an asset or a liability
 - The objective or the mission of the government
 - The characteristics of the government
 - The relative significance of assets and liabilities measured at fair value compared to total assets and liabilities
 - Whether separately issued financial statements are available
 - Line items presented in the statement of net position

Note Disclosures (continued)

- **Recurring vs. Non-recurring Measurements**
 - **Recurring** – Required or permitted in the statement of net position at the end of each reporting period
 - **Non-recurring** – Required or permitted in the statement of net position in particular circumstances

Note Disclosures (continued)

- The following information for each class or type of assets and/or liabilities measured at fair value should be disclosed:
 - The fair value measurement at the end of the reporting period and for nonrecurring fair value measurements, the reasons for the measurement
 - The level of the fair value hierarchy within which the fair value measurements are categorized in their entirety (Level 1, 2, or 3)
 - A description of the valuation technique(s)
- Table *or* narrative format

Example—Classifying Investments by Level of Inputs in a Table Format

	12/31/X1	Level		
		1	2	3
Debt securities				
U.S. Treasuries	\$85	\$85		
Commercial mortgage backed securities	50			\$50
Collateralized debt obligations	35			35
Residential mortgage backed securities	149		\$24	125
Corporate bonds	84		84	
Total	403	\$85	\$108	\$210
Investments measured at NAV (detailed)	222			
Investment derivatives (detailed)	57			
...				

Example—Classifying Investments by Level of Inputs in a Narrative Format

(Generally used when an investment portfolio is not complex)

- The city had following fair value measurements as of June 30, 2016:
 - U.S. Treasury securities of \$45 million are valued using quoted market prices (Level 1 inputs)
 - Corporate bonds of \$12 million are valued using a matrix pricing model (Level 2 inputs)

Fair Value Note Disclosure: Implementation Question

- Scenario

- A government holds cash equivalents.

- Question

- Are all cash equivalents subject to the fair value disclosure requirements of Statement 72?

- Answer

- Generally no, because cash equivalents generally are measured at other than fair value (amortized cost).
- However, if a cash equivalent is measured at fair value, the fair value disclosure requirements of Statement 72 apply.

Fair Value Hierarchy for Participants in External Investment Pools

(I.G. Update 2017-1, Q&A 4.36; 2017-2018 CIG, Q&A 6.22.7)

- If a pool elects to measure all its investments at amortized cost following Statement 79:
 - Participants' investment positions in that pool also should be measured at amortized cost.
 - Positions should not be categorized within fair value hierarchy.

- If a pool measures its investments at fair value:
 - Participants' investment positions in that pool also should be measured at fair value.
 - Positions are not required to be categorized within fair value hierarchy.
 - This is the case regardless of whether the pool transacts with participants at a fixed net asset value per share (for example, \$1.00), or at a floating net asset value per share.

Example—Classifying Investments by Level of Inputs Using Table Format

	12/31/X1	Level		
		1	2	3
Debt securities				
U.S. Treasuries	\$85	\$85		
Commercial mortgage backed securities	50			\$50
Collateralized debt obligations	35			35
Residential mortgage backed securities	149		\$24	125
Corporate bonds	84		84	
Total	403	\$85	\$108	\$210
Position in investment pool	287			
Investments measured at NAV (detailed)	222			
Investment derivatives (detailed)	57			

Disclosures for Investments in Certain Entities That Calculate NAV

- Information that helps users of its financial statements to understand the nature and risks of the investments
- Information on whether the investments are probable of being sold at amounts different from net asset value per share (or its equivalent)
- Fair value measurement of the investments in the class and a description of the significant investment strategies of the investee(s) in the class

Disclosures for Investments in Certain Entities that Calculate NAV (continued)

- If distributions are received through liquidation of the underlying assets of investees, an estimate of the period of time over which underlying assets are expected to be liquidated
- Amount of unfunded commitments related to investments in the class
- General description of the terms and conditions upon which the government may redeem investments in the class
- The circumstances in which an otherwise redeemable investment in the class might not be redeemable; or if the investment is currently restricted, when the restriction lapses

Disclosures for Investments in Certain Entities that Calculate NAV (continued)

- Any other significant restriction on the ability to sell investments in the class at the measurement date
- If it is probable that the investment will be sold at an amount different from NAV per share
 - Disclosure of the total fair value of all investments that meet the above and any remaining actions required to complete the sale
 - If individual investments to be sold have not been identified, disclosure of plans to sell and any remaining actions required to complete the sale

Questions?

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Leases

In June 2017, the GASB established new guidance that establishes a single approach to accounting for and reporting leases by state and local governments. The approach is based on the principle that leases are financings of the right to use an underlying asset.

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Website Resources

- Free download of Statements, Implementation Guides, Concepts Statements and other pronouncements
- Free access to the basic view of Governmental Accounting Research System (GARS)
- Free copies of proposals
- Up-to-date information on current projects
- Articles and Fact Sheets about proposed and final pronouncements
- Form for submitting technical questions
- Educational materials, including podcasts

Plain-Language Materials

- The GASB is committed to communicating in plain language with constituents about its standards and standards-setting activities.
- Newly revised version of “Why Governmental Accounting Is—and Should Be—Different” (October 2017)
- Fact Sheets are prepared for complex projects to answer commonly raised questions
 - Series of 8 fact sheets on Statements 67 & 68 on pensions
- Series of 7 brief videos developed regarding the Invitation to Comment on governmental fund financial statements