

GASB 72

Fair Value Measurement and Application



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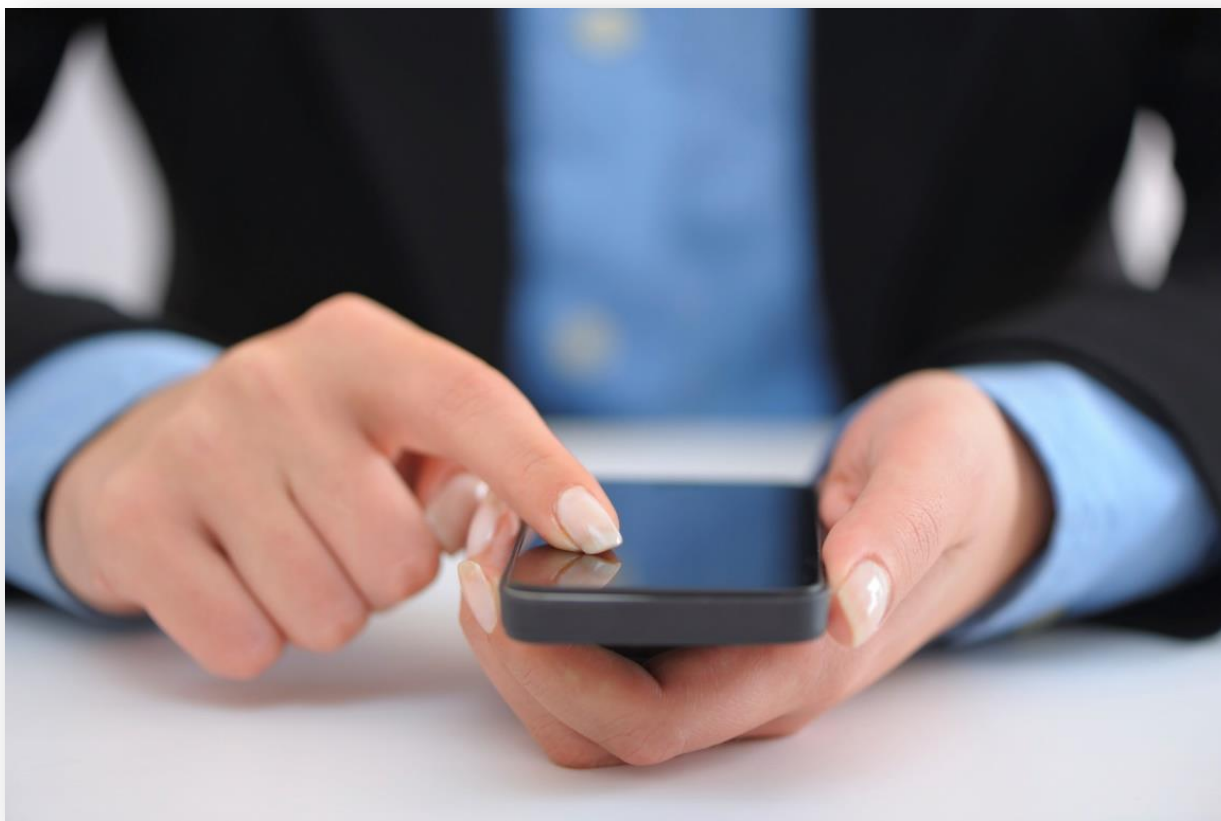
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About the Speaker

Shelly L. Hammond, CPA, CGFM



- Leads AGH's public sector practice
- 22 years' experience, specializing in providing auditing and consulting services to a variety of governmental and nonprofit entities
- Member of the AICPA's State & Local Government Expert Panel
- Past member of the AICPA's Government Audit Quality Center Executive Committee
- Member of the:
 - American Institute of Certified Public Accountants
 - Government Finance Officers Association
- Serves on the GFOA Certificate of Achievement Review Committee

Learning Objectives

- Understand what is meant by “Fair Value”
- Learn about valuation techniques for measuring fair value
- Identify how GASB defines an “investment”
- Learn how transparency and comparability are enhanced with new disclosure requirements
- Outline implementation steps



Polling Question #1

Overview – GASB's Goals

The GASB Board issued Statement 72 to update the existing standards on fair value (primarily Statement 31).

Review of existing standards found opportunities to:

- Increase comparability of financial statements by requiring that items measured at fair value use a consistent definition of fair value and accepted valuation techniques
- Enhance disclosures to provide more information to financial statement users about the impact of fair value measurements on a government's financial position.

Effective Date & Transition

- Effective for financial statements for periods beginning after June 15, 2015 (i.e., for years ended June 30, 2016 and December 31, 2016)
- In the period first applied, changes made to comply with GASB 72 should be treated as an adjustment of prior periods, and financial statements presented for the prior periods should be restated.
 - If not practical to restate prior periods, the cumulative effective should be reported as a restatement of beginning net position or fund balance



What is Fair Value?

Definition of Fair Value

Fair Value

The price that would be received to sell an asset, or paid to transfer a liability (known as the **exit price**), in an **orderly transaction** between **market participants** at the **measurement date**

Fair Value Definition

FASB 157 / ASU 820	GASB – Current	GASB 72
Fair value is 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	The amount at which an investment could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale	Fair value is 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

- Market-based measurement
- It is an **exit price** at the measurement date, from the perspective of a market participant that controls the asset or is obligation for the liability.



Fair Value: Orderly Transaction

Assumes exposure to the market for a period before the measurement date; not a forced transaction (such as a liquidation or distress sale)

Circumstances that may indicate a transaction is not orderly:

- Period of exposure to the market before the measurement date was not adequate to allow for usual and customary marketing activities.
- The seller marketed the asset or liability to a single market participant.
- The seller is in or near bankruptcy (distressed).
- The seller is required to sell to meet regulatory or legal requirements.
- The transaction price is an outlier when compared to other recent transactions for similar assets or liabilities.

Fair Value: Market Participant

Market participants:

- Are independent of each other (not related parties)
- Are knowledgeable, having a reasonable understanding of the asset or liability and the transaction
- Are able to enter into a transaction
- Are willing to enter into a transaction (i.e., are not forced or otherwise compelled to do so)

Fair Value: Other considerations

Unit of Account: Fair value is based on either a) a single asset or liability, or b) a group of assets or liabilities.

- Fair value is measured based on the unit of account – i.e., level of aggregation / disaggregation.

Market-Based: Assumes transactions take place in a government's:

- Principal market – Typically the market in which the government normally would enter into a transaction (market with the greatest volume or level of activity), or
- Most advantageous market – Determination takes into account both transaction and transportation costs

Fair Value: Other considerations

Transaction costs:

- Are excluded from the determination of fair value
- Such costs are not a characteristic of the asset or liability (they are specific to the transaction).

Transaction costs exclude **transportation costs**.

- If location is a characteristic of the asset, the price should be adjusted for costs incurred to transport the asset from its location to the market.
- Example: may happen with certain commodities

Polling Question #2



Valuation Techniques

Valuation techniques

- Appropriate under the circumstances
- Sufficient data is available.
- Maximize use of **observable inputs**
- Minimize use of **unobservable inputs**
- Should be consistent with one of three approaches (may use multiple techniques if needed)
- Should be consistently used each period



Approach #1: Market Approach

Based on prices and other information generated by market transactions involving identical or similar assets and liabilities

- Quoted market prices from an active market
- Market multiples (price earnings ratios of similar companies)
- Matrix pricing

Approach #2: Cost Approach

Based on amount required currently to replace present service capacity of an asset

- I.e., the cost a buyer would incur to acquire or construct a substitute asset of comparable utility

Approach #3: Income Approach

Based on related future amounts (for example, cash flows or revenues / expenses) converted to a single amount

- Discounted presented value techniques
- Option pricing models

Valuation Inputs: The Fair Value Hierarchy

Hierarchy of inputs

Level 1 inputs: highest quality

Level 2 inputs

Level 3 inputs: lowest quality

Basic principle: Maximize use of higher level (observable) inputs and minimize use of lower level (unobservable) inputs

Valuation Inputs

Observable vs. unobservable Inputs

- Quoted market prices in an active market (observable) should be the starting point.
- Other inputs should be consistent with the nature of the asset or liability.
 - Example: When measuring fair value of a controlling interest, a *control premium* would be a characteristic to consider.

The Fair Value Hierarchy

Level 1 – Directly observable inputs

- Quoted prices in active markets for identical assets or liabilities

The Fair Value Hierarchy

Level 2 – Inputs observable for the asset or liability either directly or indirectly

- Quoted price for similar assets or liabilities in active markets
- Quoted prices for identical or similar assets or liabilities in markets that are not active
- Other observable inputs (yield curves, credit spreads)
- Market-corroborated inputs (by observable data, correlation, or other means)

The Fair Value Hierarchy

Level 3 – Unobservable inputs

- Begin with internally generated data
- Adjust for factors as would other market participants and for something only available to the entity (an entity-specific synergy)

A Note about Liabilities

Liabilities may also be measured at fair value.

- Most common: certain derivative instruments, like an interest rate swap
- Assumes that liability is transferred to a market participant at the measurement date (not settled or extinguished)
- Fair value should consider the effect of nonperformance risk (such as an entity's credit risk).

Polling Question #3



Definition of Investments

Definition:

A security or other asset that (a) a government holds primarily for the purpose of income or profit **and** (b) has a present service capacity based solely on its ability to generate cash, or to be sold to generate cash

Held for Income or Profit

- Income-producing real property in a pension plan
- The same property, if held / managed by the primary government, may instead be a capital asset



Present Service Capacity

- Present service capacity refers to a government's mission to provide services
- Investments can be used to pay for goods or services that in turn are used to provide services directly to citizens (i.e., investments have *indirect* service capacity).



Ability to Generate Cash

- The fact that a financial instrument generates cash does not, in itself, mean that it is an investment.
 - Example: Mortgage loans are not investments if the loans arise from a program that extends financing to first time homebuyers.

Examples

- 1) Public university holds student loan receivables.
- 2) Housing agency holds mortgage loan receivables – part of a program to encourage home ownership.
- 3) City owns life insurance policies on key employees.
- 4) Pension plan owns royalty interest in oil / gas property.

Investments Requiring Fair Value Measurement

Alternative investments reported by endowments

Equity securities (including unit investment trusts and closed-end mutual funds), stock warrants and stock rights that do not have readily determinable fair values

Intangible assets meeting the proposed definition of investments

Land and land rights, including oil and gas properties, classified as investments

Commingled investment pools that are not government sponsored

Invested securities lending collateral

Real estate meeting the definition of an investment asset

Life settlement contracts (when there is no insurable interest, the purpose of the instrument is solely to generate cash)

Debt securities reported as assets (regardless of whether they meet the definition of an investment or they were acquired or originated by the government)

Securitized debt obligations

Use of NAV for Fair Value

- Net Asset Value = NAV
- Permitted to establish the fair value using NAV per share if an entity does not have a readily determinable fair value
- Example: member units or an ownership interest in partners' capital
- NAV generally calculated according to FASB principles for investment companies

Debt Securities

Debt securities reported as assets are reported at fair value – whether acquired or originated by the government.

Example: Loans acquired or originated by a government such as mortgage loans acquired by a housing finance agency



Exceptions to Fair Value

Money markets and participating interest-earning investment contracts that have remaining maturities at time of purchase of 1 year or less: Measure at **amortized cost** (does not apply if held by an external investment pool).

Investments **held by** 2a7-like external investment pools: Measure at **amortized cost**.

Investments **in** 2a7-like external investment pools: Measure at **net asset value** (NAV) per share as determined by the pool.

Unallocated insurance contracts: Report like interest-earning investment contracts (fair value if “participating,” and cost if “non-participating”).

Synthetic guaranteed investment contracts that are fully benefit-responsive: Measure at **contract value**.

Investment in life insurance contracts: Measure at **cash surrender value**.

Certain equity interests in common stock: Measure using **equity method**.

Measured at **acquisition value**: donated capital assets, donated works of art or historical treasures

Common stock

Equity Method (GASB Statement No. 62)

Ability to exercise Significant Influence over operating / financial policies of the investee.

Presumption is that if own >20% of voting stock, you have significant influence.

Significant Influence Indicators:

- Representation on the governing body
- Participation in policy making process
- Significant intra-entity transactions
- Interchange of management personnel
- Technological dependency

Exclusions from Equity Method

Common stock held by the following:

- External investment pools
- Pension or other postemployment benefit plans
- Deferred compensation plans (IRS section 457)
- Endowments, including permanent and term endowments, and permanent funds **
- Investments using Net Asset Value (NAV) **
- Investments in joint ventures or component units

** *Additions to current guidance*

Polling Question #4



Disclosure Requirements

Current Fair Value Measurement Disclosures

GASB Statement	Disclosures Addressed
Statement 31, Accounting and Financial Reporting for Certain Investments and for External Investment Pools	Methods and significant assumptions used to estimate the fair value of investments, if fair value is based on other than quoted market prices
Statement 3, Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements	Disclosure of credit risk, custodial credit risk and interest rate risk
Statement 40, Deposit and Investment Risk Disclosures – an amendment of GASB Statement No. 3	Disclosure of credit risk, custodial credit risk and interest rate risk
Statement 53, Accounting and Financial Reporting for Derivative Instruments	Disclosure of credit risk, custodial credit risk and interest rate risk

Level of Disaggregation

Current GASB No. 40

The disclosures generally should be made for the primary government, including its blended component units. Risk disclosures also should be made for governmental and business type activities, individual major funds, nonmajor funds in the aggregate or fiduciary fund types when the risk exposures are significantly greater than the deposit and investment risks of the primary government.

Statement No. 72

The level of detail and disaggregation, and how much emphasis to place on each disclosure requirement, should take into account the following considerations:

- Nature, characteristics and risks of the asset or liability
- Level of the fair value hierarchy within which the fair value measurement is categorized
- Whether this statement or another statement specifies a type for an asset or liability (e.g., GASB 53 requires hedging vs. investment derivative disclosures)
- Objective or the mission of the government
- Characteristics of the government (e.g., if one fund has investments / risks that differ from the primary gov't)
- Relative significance of assets and liabilities
- Whether separately issued financial statements are available (such as w/ pension plans)
- Line items presented in the statement of net position

Disclosures

For each class or type of assets and/or liabilities measured at fair value, disclose:

- The fair value measurement at the end of the reporting period
- The level of the fair value hierarchy (Level 1, 2, or 3)
 - Not applicable to investments that calculate NAV or its equivalent
- A description of the valuation technique(s)
 - Including any change in a technique and reason for the change (if result is significantly impacted)
- For nonrecurring fair value measurements, the reasons for the measurement

Disclosures: NAV

- Fair value measurement of the investment type and description of the significant investment strategies of the investee
- For investments that can never be redeemed with the investees, the government's estimate of the liquidation period
- Amount of unfunded commitments
- General description of the *redemption terms and conditions*
- *Redemption restrictions*, an estimate of length of restriction period or how long restriction has been in place
- Any other significant selling restrictions
- Information regarding planned sales of investments

Example NAV Disclosure

Investment Strategy	Fair Value	Unfunded Commitments	Redemption Frequency (if currently eligible)	Redemption Notice Period
Equity long/short hedge funds	\$55		Quarterly	30-60 days
Event-driven hedge funds	45		Quarterly, annually	30-60 days
Global opportunity hedge funds	35		Quarterly	30-45 days
Multi-strategy hedge funds	40		Quarterly	30-60 days
Real estate funds	47	\$20		
Total measured at NAV	\$222			



Implementation Steps

Implementation

For most general purpose governments, the additional disclosures may be minimal because they may only be able to invest in a larger government's external investment pool or may only be able to invest in the most basic, risk-free and nearly risk-free investments (for example, governments with state statutory investment restrictions).

- These will primarily be disclosed as Level 1 or reported by the sponsor or trustee of the external investment pool.

Implementation

- Determine nature / types of investments held – which do not meet the definition of an “investment”?
- Which are Level 1 (observable inputs)?
- Which are Level 2 or 3?
 - What information is available to determine fair value?
 - How reliable is that information?
- Do any meet the criteria for exceptions to fair value?

Implementation

- Are any investments measured using NAV?
 - Do we have the information needed for NAV disclosures (investment strategies, redemption restrictions, etc.)?
 - Is NAV information available as of the measurement date (year-end), and if not, what steps do we need to take to ensure NAV properly represents fair value?
- Still need to include / consider disclosure requirements of other GASB Standards

Questions?

Thank you!



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