What You Need to Know About Fair Value Accounting

Sunday, May 22, 2016, 2:40 PM, 1 CPE Credit

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AGENDA

➢ GASB STATEMENT NO. 72: AN OVERVIEW OF THE REQUIREMENTS

➢ ACTION STEPS FOR GOVERNMENTS
GASB Statement No. 72: An Overview of the Requirements
BACKGROUND

- Effective for periods beginning after 6/15/2015
- Addresses accounting and financial reporting issues related to fair value measurements
- Provides guidance for determining a fair value measurement for financial reporting
- Also provides guidance for applying fair value to certain investments and disclosures related to all fair value measurements
STATEMENT OBJECTIVES

- Primarily clarifies/expands on GASB Statement No. 31 and Statement No. 53
- Review/revise the definition of fair value
- Clarify the methods used to measure fair value
- Determine the applicability of fair value guidance to investments/other items currently reported at fair value
- Determine potential disclosures about fair value measurements
GENERAL PRINCIPLES

- WHAT IS FAIR VALUE?
- ASSETS, LIABILITIES AND UNITS OF ACCOUNT
- PRINCIPAL VS. ADVANTAGEOUS MARKETS
- PRICE AND TRANSACTION COSTS
FAIR VALUE DEFINITION

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 is a market-based measurement, not an entity-specific measurement.
- The objective of a fair value measurement is to estimate the exit price of assets and liabilities.
- Fair value is an exit price at the measurement date from the perspective of a market participant that controls the asset or is obligated for the liability.
ASSETS, LIABILITIES AND UNITS OF ACCOUNT

- The item(s) to be valued could be a
  - Single asset or liability, such as a financial instrument;
  - A group of assets or a liabilities; or
  - A group of related assets and liabilities, such as a partnership

- Unit of account refers to the level at which an asset or a liability is aggregated or disaggregated for measurement, recognition, or disclosure purposes.

- Transaction costs, such as commissions, do not meet the definition of an asset and should be recognized as expenses when incurred.
PRINCIPAL & ADVANTAGEOUS MARKET

In a fair value measurement, the sale of an asset or the transfer of a liability would be expected to take place in the principal market for the asset or liability.

- The principal market is the market that the government would normally enter into for its transactions.

- In the absence of a principal market, the government may use the most advantageous market.
  - The determination takes into account both transaction and transportation costs.
  - Most advantageous market...
PRINCIPAL & ADVANTAGEOUS MARKET

To identify the principal market, the government should take into account all information that is reasonably available.

- A government should have access to the principal or most advantageous market at the measurement date.

- Access to the market is needed, but the government does not need to be able to sell the asset or transfer the liability at the measurement date.

- The assumed transaction is the basis for the fair value price.
PRICE AND TRANSACTION COSTS

- Quoted prices are the **most preferable** source for fair value information.

- Certain market conditions may make quoted prices **less reliable** for fair value measurement.

- Additional analysis of quoted market prices is needed in the presence of material changes in the volume, nature or level of activity for “normal” market activity.

- If support/evidence exists that a transaction is not orderly, a government would rely **less**, if at all, on the transaction price.
VALUATIONS AND APPROACHES

VALUATION TECHNIQUES AND INPUTS

- OBSERVABLE VS. UNOBSERVABLE

VALUATION APPROACHES

- MARKET APPROACH
- COST APPROACH
- INCOME APPROACH
VALUATION TECHNIQUES AND INPUTS

Valuation techniques are used to determine fair value.

- Governments should use valuation techniques that are appropriate to the circumstances and for which sufficient data is available to measure fair value.

- Must consider the difference between observable and unobservable inputs when determining fair value.

- It is preferable to use observable inputs such as quoted prices in active markets, rather than less reliable, non-objective, internally generated information (unobservable).
VALUATION APPROACHES

Apply valuation technique(s) that best represent fair value in the circumstances using one of the three approaches:

- **Market approach:** Uses prices and other relevant data derived from market transactions for identical or similar assets, liabilities, or a group of assets and liabilities.

- **Cost approach:** Reflects the amount that would be required currently to replace the present service capacity of an asset.

- **Income approach:** Converts future amounts to a single discounted amount. The fair value measurement would also reflect any current market expectations for future amounts.
VALUATION TECHNIQUES AND INPUTS

Apply valuation technique(s) that best represent fair value in the circumstances using one of the three inputs:

**Level 1**-Most Reliable
Quoted prices **(unadjusted)** in active markets for identical assets or liabilities

**Level 2**-Reliable
Quoted prices for similar assets or liabilities, quoted prices for identical or similar assets or liabilities in markets that are not active, or other observables

**Level 3**-Least Reliable
Unobservable inputs
INVESTMENTS

- DEFINITION
- INCLUSIONS
- EXCEPTIONS
INVESTMENTS

An investment is a security or other asset that is held primarily for the purpose of income or profit.

- It has a present service capacity that is based solely on its ability to generate cash or to be sold to generate cash.

- Service capacity refers to a government’s mission to provide services.

- Held primarily for income or profit—acquired first and foremost for future income and profit.

- Assets that meet the definition of an investment generally are to be measured at fair value.

- Exceptions to fair value include money market funds or 2a7-like external investment pools.
What is the asset’s purpose?

- The “purpose” of the asset is determined by the government at the time of acquisition.

- Once the government determines whether the asset is an investment or another type of asset, the classification should be retained for future financial reporting purposes—even if the government’s usage of the asset changes over time.

- If an asset is initially reported as a capital asset and then later is held only for resale, the asset should not be reclassified as an investment.
EXAMPLES

- **Example #1-Mortgage Loans:** Are not investments if the loans are the result of a government’s program that provides financing to first-time homebuyers. The present service capacity of the loans is not based solely on the loans’ ability to generate cash.

- **Example #2-Capital Assets:** Once the government determines whether the asset is an investment or another type of asset, the classification should be retained for financial reporting purposes, even if the government’s usage of the asset changes over time.
LIABILITIES

- BASIC PRINCIPLES

- LIABILITIES HELD BY OTHER PARTIES AS ASSETS
LIABILITIES

- **Basic Principles:** Measurement of the fair value of a liability (for example, an interest rate swap that is in a liability position to a government) assumes that the liability is transferred to a market participant at the measurement date.

- **Liabilities Held By Other Parties:** If a quoted price for the transfer of an identical or similar liability is not available and the identical item is held by another party as an asset, a government should measure the fair value of the liability similar to how the asset would be measured.
FINANCIAL REPORTING DISCLOSURES

The following information is required for each class or type of assets and/or liabilities measured at fair value:

- FV measurement at the end of the reporting period and for nonrecurring FV measurements, the reasons for the measurement.
- Level of the FV hierarchy/Inputs showing how each of the FV measurements are categorized (Level 1, 2, or 3).
- Description of the valuation technique(s) used.
- FV measurements categorized within Level 3 of the fair value hierarchy.
- The effect of those investments on investment income for the reporting period.
EXAMPLE DISCLOSURE – CITY GOVERNMENT

Illustrative Disclosure

The City categorizes its fair value measurements within the fair value hierarchy established by generally accepted accounting principles. The hierarchy is based on the valuation inputs used to measure the fair value of the asset. Level 1 inputs are quoted prices in active markets for identical assets; Level 2 inputs are significant other observable inputs; Level 3 inputs are significant unobservable inputs.

The City has the following recurring fair value measurements as of June 30, 20X1:

- U.S. Treasury securities of $45 million are valued using quoted prices in an active market for identical assets (Level 1 inputs)
- Corporate bonds of $12 million are valued using a matrix pricing model (Level 2 inputs)
EXAMPLE DISCLOSURE – PENSION PLAN

Investments and Derivative Instruments Measured at Fair Value
($ in millions)

<table>
<thead>
<tr>
<th>Investments by fair value level</th>
<th>12/31/X1</th>
<th>Quoted Prices in Active Markets for Identical Assets (Level 1)</th>
<th>Significant Other Observable Inputs (Level 2)</th>
<th>Significant Unobservable Inputs (Level 3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt securities</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>U.S. Treasury securities</td>
<td>$ 85</td>
<td>$ 85</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commercial mortgage-backed securities</td>
<td>50</td>
<td>$ 45</td>
<td></td>
<td>$ 5</td>
</tr>
<tr>
<td>Collateralized debt obligations</td>
<td>30</td>
<td>5</td>
<td></td>
<td>25</td>
</tr>
<tr>
<td>Residential mortgage-backed securities</td>
<td>149</td>
<td>24</td>
<td></td>
<td>125</td>
</tr>
<tr>
<td>Corporate bonds</td>
<td>93</td>
<td>9</td>
<td></td>
<td>84</td>
</tr>
<tr>
<td>Total debt securities</td>
<td>407</td>
<td>94</td>
<td>158</td>
<td>155</td>
</tr>
<tr>
<td>Equity securities</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Financial services industry</td>
<td>150</td>
<td>150</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Healthcare industry</td>
<td>110</td>
<td>110</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>15</td>
<td>15</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total equity securities</td>
<td>275</td>
<td>275</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### EXAMPLE DISCLOSURE – PENSION PLAN CONT’D

<table>
<thead>
<tr>
<th>Venture capital investments</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct venture capital—healthcare</td>
<td>53</td>
<td>53</td>
</tr>
<tr>
<td>Direct venture capital—energy</td>
<td>32</td>
<td>32</td>
</tr>
<tr>
<td><strong>Total venture capital investments</strong></td>
<td><strong>85</strong></td>
<td><strong>85</strong></td>
</tr>
<tr>
<td>Private equity funds—international</td>
<td>43</td>
<td>43</td>
</tr>
<tr>
<td><strong>Total investments by fair value level</strong></td>
<td><strong>810</strong></td>
<td><strong>$ 369</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Investments measured at the net asset value (NAV)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity long/short hedge funds</td>
<td>55</td>
</tr>
<tr>
<td>Event-driven hedge funds</td>
<td>45</td>
</tr>
<tr>
<td>Global opportunities hedge funds</td>
<td>35</td>
</tr>
<tr>
<td>Multi-strategy hedge funds</td>
<td>40</td>
</tr>
<tr>
<td>Real estate funds</td>
<td>47</td>
</tr>
<tr>
<td><strong>Total investments measured at the NAV</strong></td>
<td><strong>222</strong></td>
</tr>
<tr>
<td><strong>Total investments measured at fair value</strong></td>
<td><strong>$ 1,032</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Investment derivative instruments</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest rate swaps</td>
<td>$ 57</td>
</tr>
<tr>
<td>Foreign exchange contracts (liabilities)</td>
<td>(43)</td>
</tr>
<tr>
<td><strong>Total investment derivative instruments</strong></td>
<td><strong>$ 14</strong></td>
</tr>
</tbody>
</table>

**NOTE:** This represents the fair value hierarchy table portion of the disclosure only, and excludes the narrative portions of this disclosure.
# EXAMPLE DISCLOSURE – PENSION PLAN CONT’D

## Investments Measured at the NAV
($ in millions)

<table>
<thead>
<tr>
<th>Investment Type</th>
<th>Fair Value</th>
<th>Unfunded Commitments</th>
<th>Redemption Frequency (If Currently Eligible)</th>
<th>Redemption Notice Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity long/short hedge funds (1)</td>
<td>$ 55</td>
<td></td>
<td>Quarterly</td>
<td>30–60 days</td>
</tr>
<tr>
<td>Event-driven hedge funds (2)</td>
<td>45</td>
<td></td>
<td>Quarterly, annually</td>
<td>30–60 days</td>
</tr>
<tr>
<td>Global opportunities hedge funds (3)</td>
<td>35</td>
<td></td>
<td>Quarterly</td>
<td>30–45 days</td>
</tr>
<tr>
<td>Multi-strategy hedge funds (4)</td>
<td>40</td>
<td></td>
<td>Quarterly</td>
<td>30–60 days</td>
</tr>
<tr>
<td>Real estate funds (5)</td>
<td>47</td>
<td>$ 20</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total investments measured at the NAV</strong></td>
<td><strong>$ 222</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private equity funds—international (6)</td>
<td>$ 43</td>
<td>$ 15</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**NOTE:** This table will be accompanied by additional narrative disclosures describing the fund strategies and how fair value has been calculated for each investment.
Action Steps for Governments
STEP 1: IDENTIFY ITEMS AT FAIR VALUE

- Begin by developing a listing of the assets and liabilities you will be required to report at fair value.

- Paragraph 64 of GASB 72 requires investments to be reported at fair value.

- Per Basis of Conclusions paragraph B3, GASB 72 does not require anything else to be reported at fair value unless another GASB statement has already required it to be reported at fair value.
STEP 1: IDENTIFY ITEMS AT FAIR VALUE

- Most common other asset/liability at fair value is derivative instruments per GASB 53:
  - Interest rate swaps
  - Foreign currency exchange contracts
  - Fuel purchase contracts
  - Others?
STEP 2: DETERMINE FAIR VALUE SOURCE

- Determine what the source of the fair value information will be for each item.
  - Quoted market prices as determined by the government
  - Pricing services or brokers
  - Audited financial statements or other statements received from alternative investment funds
  - Appraisals (how often are these prepared?)

- Don’t simply rely on the fair value reported to you on monthly bank statements or brokerage statements. Contact the financial institution to understand how they determine the fair value.
STEP 3: CONTACT PRICING SERVICES

- For fair value quotes obtained from pricing services or brokers, contact them to clarify how they determine the price quote.
- Actual quoted market prices (level 1)
- Pricing models or matrices (generally level 2)

- Keep in mind that U.S. Treasury and agency securities and corporate bonds are often priced using models or matrices and thus would be level 2.
- Refer to GASB 72, Illustration 2, example 1
STEP 4: ADDRESS INVESTMENTS AT NAV

For investments measured at Net Asset Value (NAV), various specific steps should be performed, as follows:

- A. Obtain the investment fund agreement and/or contact the fund to obtain the necessary information for the disclosure.
  - Unfunded commitments
  - Redemption frequency and notice period
  - Fund strategy and method for determining fair value
STEP 4: ADDRESS INVESTMENTS AT NAV

B. Consider the source and reliability of fair value information:

- Statements provided by the fund itself: are these sufficiently independent to rely upon?

- Audited financial statements for the fund are preferred. Make sure these financial statements are:
  - Presented in accordance with U.S. generally accepted accounting principles
  - An unmodified opinion was rendered by the auditors
  - Information can be extracted in order to value your share of the fund (for ex., a net asset value per share)
STEP 4: ADDRESS INVESTMENTS AT NAV

C. Consider the timeliness of fair value information:

- Statements provided by the fund are often on a one-month or one-quarter lag. Make sure the information you are using is actually as of your financial statement date.

- Audited financial statements involves the following issues:
  - For some funds, these are not available until 5-6 months after year end
  - Most funds have December 31st fiscal year-ends. This could be problematic if your fiscal year-end is something other than December 31.
STEP 4: ADDRESS INVESTMENTS AT NAV

- Remember that, per paragraph 71 of GASB 72, these provisions apply to investments valued at NAV or its equivalent.
- Some funds calculate a net asset value per share.
- Other funds simply report the dollar value of your capital account. This is considered to be the equivalent of NAV.
STEP 5: CLASSIFY FAIR VALUE BY LEVEL

- Make a first attempt to classify fair values for all assets and liabilities within the Level 1, 2, and 3 classification scheme.

- Beware of corporate bonds, U.S. Treasuries and U.S. agency securities, which are often level 2.

- Beware of publicly traded alternative investment funds (which must be classified in the level 1/2/3 scheme) vs. alternative investment funds reported at NAV (which are not classified in the level 1/2/3 scheme).
STEP 6: ACCUMULATE DISCLOSURE INFO

- Determine whether all necessary information to prepare the narrative portion of the footnotes is available, as required by paragraph 81 of GASB 72:
  - Description of valuation techniques
  - Nature of any material changes in valuation techniques
  - Nonrecurring fair value measurements and the reason (for example, capital asset impairments, per Illustration 5, example 1)
  - Required disclosures for those investments reported at NAV
STEP 6: ACCUMULATE DISCLOSURE INFO

- Also, determine at what level assets and liabilities will be aggregated for footnote disclosure purposes.

- Follow the guidance in GASB 72, paragraph 80.
STEP 7: PREPARE DRAFT DISCLOSURE

- Prepare a first draft of your fair value disclosure.
- Consider sharing this draft with your auditors prior to the start of your financial statement audit, so they can concur with/challenge your:
  - Source of fair value information
  - Level of aggregation
  - Classification as level 1, 2, or 3
  - Thoroughness of disclosure
- This will give you sufficient time to make corrections as necessary.
STEP 8: DONATED CAPITAL ASSETS

- Per GASB 72, paragraph 79, these are now to be reported at acquisition value (an entry price).
- Most common examples are donated infrastructure and donated art and historical treasures.
STEP 8: DONATED CAPITAL ASSETS

- For donated infrastructure:
  - Are you notified of donated infrastructure as it is received?
  - Do you receive construction cost information from the developer?
  - If not, do you have a process in place to estimate the acquisition cost:
    - Accumulate the number of lane miles or square feet obtained
    - Have a current construction cost per lane mile or square foot available
    - Multiply these to calculate an estimated acquisition cost
STEP 8: DONATED CAPITAL ASSETS

- For donated art and historical treasures:
  - Are you notified of donated art and historical treasures as it is received?
  - Do you receive cost or appraisal information from the donor?
  - If not, do you have a process in place to estimate the acquisition cost (e.g. An appraisal process)?
QUESTIONS?