GASB Statement No. 72 – Fair Value Measurement and Application

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The time to implement the GASB standard on fair value measurements has arrived. This requirement is effective for fiscal years ending June 30, 2016, and entities who utilize a GASB financial reporting framework may have concerns about implementing this new standard properly. This article will help guide you through these requirements.

Background

In March of 2015, the GASB released Statement 72, Fair Value Measurement and Application. This Statement addresses accounting and financial reporting issues related to fair value measurements for assets (such as investments) and liabilities (such as split-interest agreements), and provides guidance for determining a fair value measurement for financial reporting purposes. It also provides guidance for disclosures related to all fair value measurements. The goal is to enhance comparability of financial statements by using consistent definitions and accepted valuation techniques. The disclosures are intended to provide comprehensive information to the users of the financial statements about the impact of fair value measurements to the entity's financial position.

Points to Consider

- What assets and liabilities may be subject to fair value measurement?
- Is the existing internal control system sufficient to properly observe, measure, and report on fair value?
- Are the current information systems adequate to meet the new valuation and reporting needs?
- Are you closely reviewing reports from investment managers or other external pricing services to ensure valuation changes are correctly reported?

How the Changes Impact Financial Statement Disclosures

The following disclosures are required for recurring and nonrecurring fair value measurements:

1. Fair value measurement at the end of the reporting period
2. Level of fair value hierarchy (excluding any investments measured at NAV as a practical expedient)
3. A description of the valuation techniques used
4. For significant changes in valuation techniques, the changes and the reason for making them

Fair Value Hierarchy Explained

The accounting standards break down the fair value hierarchy into three levels, based on how observable the inputs are that make up the valuation. The most observable inputs are classified as Level 1 where the unobservable inputs are classified as Level 3.

Level 1 inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets that the Entity has the ability to access.

Examples of Level 1 inputs for particular assets and liabilities include the following:

1. *Common and preferred stock*
2. *Mutual funds*
3. *Long duration fixed income funds*
4. *Exchange traded funds*
5. *Comingled investment pools that are not government sponsored may be valued at Level 1 or Level 2, depending on the circumstances.*

As a general rule, any asset that has a daily closing price and is actively traded will be classified as a Level 1 input.

Level 2 inputs are inputs (other than quoted prices included within Level 1) that are observable for the asset or liability, either directly or indirectly. Inputs to the valuation methodology include: (1) quoted market prices for similar assets or liabilities in active markets, (2) quoted prices for identical or similar assets or liabilities in inactive markets, (3) inputs other than quoted prices that are observable for the asset or liability, and (4) inputs that are derived principally from or corroborated by observable market data by correlation or other means. If the asset or liability has a specified (contractual) term, the Level 2 input must be observable for substantially the full term of the asset or liability.

Examples of Level 2 inputs for particular assets and liabilities include the following:

1. *Bond or fixed income fund valued by a pricing service that uses matrix pricing.* A Level 2 input would be a price or yield of a similar bond.
2. *Interest Rate Swaps - Pay-fixed, receive-variable interest rate swap based on the London Inter-bank Offered Rate (LIBOR) swap rate.* A Level 2 input would be the LIBOR swap rate if that rate is observable at commonly quoted intervals for substantially the full term of the swap.
3. *Comingled investment pools that are not government sponsored may be valued at Level 1 or Level 2, depending on the circumstances.*
4. *Three-year option on exchange-traded shares. A Level 2 input would be the implied volatility for the shares derived through extrapolation to Year 3 if both of the following conditions exist:*
    a. *Prices for one-year and two-year options on the shares are observable.*
    b. *The extrapolated implied volatility of a three-year option is corroborated by observable market data for substantially the full term of the option. In that case, the implied volatility could be derived by extrapolating from the implied volatility of the one-year and two-year options on the shares and corroborated by the implied volatility for three-year options on comparable entities' shares, provided that correlation with the one-year and two-year implied volatilities is established.*

As a general rule, if an asset or liability does not fall into the requirements of a Level 1 or Level 3 input, it would default to Level 2. With Level 2 inputs, there is usually data that can be easily obtained to support the valuation, even though it is not as easily obtained as a Level 1 input would be.

Level 3 inputs to the valuation methodology are unobservable and significant to the fair value measurement.

Examples of assets and liabilities that use Level 3 inputs include the following:

1. *Long-dated currency swap.* A Level 3 input would be an interest rate in a specified currency that is not observable and cannot be corroborated by observable market data at commonly quoted intervals or otherwise for substantially the full term of the currency swap. The interest rates in a currency swap are the swap rates calculated from the respective countries' yield curves.
2. *Three-year option on exchange-traded shares.* A Level 3 input would be historical volatility, that is, the volatility for the shares derived from the shares' historical prices. Historical volatility typically does not represent current market participants' expectations about future volatility, even if it is the only information available to price an option.
3. *Interest rate swap.* A Level 3 input would be an adjustment to a midmarket consensus (nonbinding) price for a swap developed using data that are not directly observable and cannot otherwise be corroborated by observable market data.
4. *Real assets (real estate).* A Level 3 input would be a financial forecast (for example, of cash flows or earnings) developed using a government's own data if there is no reasonably available information that indicates that market participants would use different assumptions.
5. *Split-Interest Obligations.* A level 3 input would be life annuity for property donated to the entity with a corresponding liability to the donor.

As a general rule, Level 3 inputs are those that are difficult to obtain on a regular basis and require verification from an outside party, such as an auditor or an appraisal, to validate the valuation.

What is NAV?

Net asset value (NAV) is a common measure of fair value for Level 1, Level 2, and Level 3 investments. A fund's NAV is simply its assets less its liabilities, and is often reported as a per share amount for fair value measurement purposes. The investing entity would multiply the NAV per share by the shares owned to arrive at fair value. Level 1 investments in funds such as mutual funds report at a daily NAV per share and are actively traded. NAV also comes in to play for Level 2 and 3 investments. As a matter of convenience (or referred to in accounting literature as

What is NAV? (continued)

a "practical expedient"), an Entity can use the NAV per share for investments in a nongovernmental entity that does not have a readily determinable fair value, such as an alternative investments reported by endowments. One caveat is that the NAV is not permitted for valuation if it is probable that the Entity will sell the investment at a different price. Investments measured at NAV as a practical expedient would be excluded from the fair value hierarchy because the valuation is not based on actual market inputs, but rather is quantified using the fund's reported NAV as a matter of convenience. The enclosed illustrative disclosure will reflect how these investments should be treated in the fair value measurements footnotes.

Examples of assets measured at NAV as a practical expedient include the following:

1. Private equity funds – valued at the NAV of units held, as reported by the fund advisor or general partner.
2. Hedge strategies – valued at the NAV of units held, as reported by the investment manager.

Recurring and Nonrecurring Fair Value Measurements

While the majority of fair value measurements for any organization are recurring, primarily for investments and derivatives, it is important to remember that many organizations may have nonrecurring fair value adjustments that occur in a particular year (an impairment loss on property and equipment). These are also required to be disclosed.

Investments Exempt from Fair Value Measurements

The following measurements will be measured in accordance with existing GASB standards and not at fair value:

• Investments in nonparticipating interest-earning investment contracts (cost-based measure)

• Money market investments and participating interest-earning investment contracts that have remaining maturity at time of purchase of one year or less and are held by governments other than external investment pools (amortized cost)

• Investments held by 2a-7 external investments pools (amortized cost)

• Investments in 2a-7 like pools (NAV per share)

• Synthetic guaranteed investment contracts that are fully benefit-responsive (contract value)

GASB vs. FASB

While this GASB Statement may seem similar to the Financial Accounting Standards Board (FASB) fair value measurement, there are some differences. One key difference being that GASB chose not to require a rollforward of level 3 assets, which is a requirement under FASB.

Another difference is that GASB does not require the fair value hierarchy to be presented in tabular format, which is a requirement under FASB. The illustrative example presented is in a tabular format.

Effective Date

The requirements are effective for financial statements for reporting periods beginning after June 15, 2015. In the period first applied, changes made to comply with this standard should be treated as an adjustment of prior periods, and financial statements presented for the periods affected should be restated. If restatement for all prior periods presented is not practical, the cumulative effect should be reported as a restatement of beginning net position for the earliest period restated, with an explanation of the reason for not restating.

If you would like to read more about GASB 72, click here to access the original GASB release.

Illustrative Footnote Disclosure:

The Entity 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 Entity has the following recurring fair value measurements as of June 30, 2016 and 2015:

- *Mutual funds* – Valued at the daily closing price as reported by the fund. Mutual funds held by the Entity are open-end mutual funds that are registered with the Securities and Exchange Commission. These funds are required to publish their daily net asset value (NAV) and to transact at that price. The mutual funds held by the Entity are deemed to be actively traded.
- *Fixed income funds* – Valued using pricing models maximizing the use of observable inputs for similar securities. This includes basing value on yield currently available on comparable securities of issuers with similar credit ratings.
- *Equity funds* – Valued at market prices for similar assets in active markets.
- *Common stock* – Valued at quoted market prices for identical assets in active markets.
- *Hedge funds and private investments* – Valued at NAV of units held, as reported by the fund advisor or general partner. The Entity reviews and evaluates the values and assesses the valuation methods and assumptions used in determining the fair value of these alternative investments. Because alternative investments are not readily marketable, NAV is used as a practical expedient, and their estimated value is subject to uncertainty and therefore may differ from the value that would have been used had a readily available market for such investments existed, and differences could be material.
- *Derivative liabilities* – Valued based on the interest rate swap agreement's valuation models and assumptions and available market data, some of which may be internally developed.
- *Split-interest obligations* – Valued annually using appropriate discount rates and actuarially determined life expectancies.

The following table summarizes the assets and liabilities of the Entity for which fair values are determined on a recurring basis as of June 30, 2016 and 2015, respectively:

Description	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Fair Value
June 30, 2016				
Mutual funds	$ 1,000,000	$ —	$ —	$ 1,000,000
Fixed income funds	2,450,00	190,000	—	2,640,00
Equity funds	—	210,000	—	210,000
Common stock	1,8000,000	—	—	1,8000,000
Total assets in the fair value hierarchy	5,250,000	400,000		5,650,000
Investments measured at net asset value*	—	—	—	1,270,000
Investments at fair value	$ 5,250,000	$ 400,000	$ —	$ 6,920,000
Derivative liabilities	$ —	$ (180,000)	$ —	$ (180,000)
Split-interest obligations	$ —	$ —	$ (190,000)	$ (190,000)
June 30, 2015				
Mutual funds	$ 1,200,000	$ —	$ —	$ 1,200,000
Fixed income funds	3,150,00	130,000	—	3,280,000
Equity funds	—	270,000	—	270,000
Common stock	2,400,000	—	—	2,400,000
Total assets in the fair value hierarchy	6,750,000	400,000		7,150,000
Investments measured at net asset value*	—	—	—	1,290,000
Investments at fair value	$ 6,750,000	$ 400,000	$ —	$ 8,440,000
Derivative liabilities	$ —	$ (200,000)	$ —	$ (200,000)
Split-interest obligations	$ —	$ —	$ (140,000)	$ (140,000)

**In accordance with GASB 72, certain investments that were measured at NAV per share (or its equivalent) have not been classified in the fair value hierarchy. The fair value amounts presented in this table are intended to permit reconciliation of the fair value hierarchy to the line items presented in the statement of net position.*

The following table discloses the nature and risk of investments for which fair value has been estimated using the net asset value per share (NAV) of the investments as a practical expedient as of June 30, 2016 and 2015, respectively:

Investments Measured at Net Asset Value as of June 30, 2016

Description		Fair Value		Unfunded Commitments	Redemption Frequency (If Currently Eligible)	Redemption Notice Period
Hedge Fund						
Fund of funds (a)	$	200,00			Quarterly-Semiannually	90-95 Days
Long/short equity (b)		310,000			Quarterly	30-180 Days
Global macro (c)		500,000			Monthly	15 Days
Private investments						
Private equity (d)		140,000	$	80,000	Illiquid	N/A
Venture capital (e)		120,000		60,000	Illiquid	N/A
	$	1,270,000		$140,000		

Investments Measured at Net Asset Value as of June 30, 2015

Description		Fair Value		Unfunded Commitments	Redemption Frequency (If Currently Eligible)	Redemption Notice Period
Hedge Fund						
Fund of funds (a)	$	420,000			Quarterly-Semiannually	90-95 Days
Long/short equity (b)		120,000			Quarterly	30-180 Days
Global macro (c)		300,000			Monthly	15 Days
Private investments						
Private equity (d)		240,000	$	90,000	Illiquid	N/A
Venture capital (e)		210,000		40,000	Illiquid	N/A
	$	1,290,000	$	130,000		

(a) Fund of funds – This category includes investments in hedge funds that invest in a portfolio of other hedge funds.

(b) Long/short equity – This category includes investments in hedge funds that invest domestically and globally in both long and short common stocks across all market capitalizations. These investments offer a low correlation to traditional long-only equity benchmarks in order to achieve absolute return. Management of the hedge funds may opportunistically shift investments across sectors, geographies, and net market exposures.

(c) Global macro – This category includes investments in hedge funds that invest in global macro strategies including long and short equities, currencies, commodities, etc. based on evaluation of macroeconomic trends.

(d) Private equity – This category includes investments in several limited partnership funds that invest in equity securities and debt of private companies or conduct buyouts of public companies the result in a delisting of public equity. The nature of the investment in this category prohibits redemptions through the duration of the partnership, which ranges between 10 to 15 years. Distributions are received through the liquidation of underlying assets of the funds.

(e) Venture capital – This category includes investments in several limited partnership funds that invest in early-stage, high-potential startup companies or small businesses that do not have access to public funding. The nature of the investment in this category prohibits redemptions through the duration of the partnership, which ranges between 10 to 15 years. Distributions are received when underlying companies are exited via acquisition or IPO.