MAULDIN & JENKINS
300 Mulberry Street
Suite 300
Macon, GA 31201

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Please contact any of our governmental partners and managers, at 1-800-277-0050 for assistance or visit our website at www.mjcpa.com.

Miller Edwards	medwards@mjcpa.com
Meredith Lipson	mlipson@mjcpa.com
Joel Black	jmblack@mjcpa.com
Wade Sansbury	wsansbury@mjcpa.com
Alison Wester	awester@mjcpa.com
Adam Fraley	afraley@mjcpa.com
Doug Moses	dmoses@mjcpa.com
Matt Hill	mhill@mjcpa.com
James Bence	jbence@mjcpa.com
David Irwin	dirwin@mjcpa.com

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Governmental Accounting News

GASB 72 on fair value, it is not totally about disclosure

By Joel Black

Governmental Accounting Standards Board (GASB) Statement No. 72, *Fair Value Measurement and Application*, is effective for fiscal year ends starting with the June 30, 2016 year-end financial statements so it's certainly time to start thinking about it if you haven't already. Many think, maybe correctly so, that this standard is all about disclosure, but there are a few other things to think about and things that will change resulting from the implementation of this standard.

Overview

This standard is broken into two distinct sections: the first covers general principles related to fair value (covered by paragraphs 5 – 63) and is similar to a concepts statement about the determination of fair value, and the second section (paragraphs 64 – 82) relates to the specific application of fair value to the accounting and disclosure within state and local governments.

Fair value is defined as 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. It is a market-based measurement and an exit price. This definition and the determinations used in GASB 72 related to fair value would be used on anything, within GASB standards, that is required to be determined at fair value.

Investments

GASB 72 requires that all investments be measured at fair value, with a few exceptions. So the first determination which must be made is, *what is an investment*? GASB 72 defines an investment as 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. This will, at times, require judgment.

An easy example would be purchasing a US Treasury Bond. This would be done by a government to generate some kind of return on the investment and is not purchased for a public purpose. The US Treasury Bond may be sold to then purchase or construct something, such as a new road, which does serve a public purchase, but the purchase of the US Treasury Bond was not, by itself, for a public purpose and would therefore be an investment. However, the purchase of a piece of property may not be quite as black and white. If the purchase of the property included some public purpose – such as to develop an underdeveloped or blighted area that the government would like to see developed, but the private sector isn't developing – then this purchase would be for a public purpose, not primarily to generate income or profit, and this would not be considered an investment. Using these examples, the US Treasury Bond is an investment and would be valued at fair value at each reporting date, however the purchase of property for development purposes is not an investment and would be valued at cost.

GASB 72 goes on to denote that this determination, about whether a transaction results in an investment or some other type of asset, should be made by management at the time of acquisition and should be retained for financial reporting purposes, even if the government's usage of the asset changes over time. For example, an asset initially reported as a capital asset and later is held for sale should not be reclassified as an investment.

Exceptions to Using Fair Value for Investments

As noted earlier, GASB 72 requires all investments to be reported at fair value, with a few exceptions. Those exceptions are listed in paragraph 69 of GASB 72 with the more commonly encountered items being:

- Investments in non-participating interest-earning investment contracts (such as nonnegotiable certificates of deposit) should be valued at cost.
- Money market investments and participating interest-earning investment contracts (such as certificates of deposit whose value is affected by market -interest rate- changes) with a remaining maturity at the time of purchase of one year or less should be valued at amortized cost.

- Investments in 2a7-like external investment pools may be measured at net asset value (NAV) per share. However this has already been amended by GASB 79, *Certain External Investment Pools and Pool Participants*, which is also effective for June 30, 2016 financial statements. GASB 79 allows external investment pools to meet less stringent criteria than the newly revised 2a7-like requirements and essentially brings the old 2a7-like criteria into GASB 79. If an external investment pool, such as the Georgia Fund 1, meets the established criteria, then investments in that pool can be measured at amortized cost and not at fair value. Note that if the external investment pool does not meet the GASB 79 criteria, then participation in the pool should be measured based on the fair value per share of the pool's underlying portfolio. In discussions with the management of the Georgia Fund 1, they have been reporting the pool at fair value for a couple of years now (as opposed to amortized cost) and plan to continue to report this way. Thus your investment in the Georgia Fund 1 will be on the fair value per share. The Georgia Fund 1 does mark all of its assets to fair value at year-end, however this adjustment is very minimal given the types of investments and their related liquidity, thus your reported share value each month is reported at fair value.

Disclosures and the Hierarchy of Investments

As noted earlier, GASB 72's disclosure requirements are where the most significant changes occur. One of the more significant disclosures relates to the fair value hierarchy. In an attempt to give readers some idea of how reliable the estimates of the fair value determinations are, the fair value hierarchy categorizes the inputs to valuation techniques used to measure fair value into three levels.

- Level 1 inputs are quoted prices (unadjusted) for identical assets or liabilities in active markets that a government can access at the measurement date. This means Level 1 estimates of fair value are the most reliable.
- Level 2 inputs are inputs – other than quoted prices included within Level 1 – that are observable for an asset or liability, either directly or indirectly. The means Level 2 estimates of fair value are essentially less reliable than Level 1, but more reliable than Level 3.
- Level 3 inputs are unobservable inputs for an asset or liability. Thus Level 3 estimates of fair value are the least reliable of the investments.

If you were like I was, you thought "Apart from pension plans, most local governments are limited to investing in very safe and common securities – I'm sure everything will be Level 1." When you read the definitions and think about the markets, that turns out not to be true. Level 1 would consist of US Treasury Bonds (probably) and common stocks (for pension plans) as these same assets are traded daily in a market that we can access. Information for these securities is readily available, and a fair value is easy to determine. However, when it comes to US Agency backed securities, these actually would typically meet the requirements of Level 2. You can easily find a value, but it may not be the exact same security – or the exact same security isn't traded daily. Level 3 investments would include investments that do not have observable inputs from a market – such as an investment in an LLC. Many "alternative" investments in a pension plan would fall under Level 3 within the hierarchy.

The disclosures required by GASB 72 should be organized by type of asset or liability. This disaggregation by type of asset would depend on the nature, characteristics, and risks of the asset or liability as well as other similar considerations. For each type of asset or liability measured at fair value, the government should disclose the following information:

- The fair value measurement at the end of the reporting period.
- 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 techniques used in the fair value measurement.
- If there has been a change in the valuation technique that has a significant impact on the result.

How Fair Value is Determined Will Be of Significance to Auditors

With the implementation of this standard, the State and Local Government Expert Panel of the AICPA took the opportunity to revamp the chapter in the Accounting and Audit Guide for State and Local Governments related to fair value. As a result of this rewritten chapter, along with implementation of GASB 72, auditors should be more interested in management's process related to determining the fair value reported in the financial statements. Management commonly utilizes others to assist in developing fair value measurements. While management may outsource certain activities associated with fair value measurements, management cannot outsource its responsibility to determine the fair value measurements and disclosures. Taking responsibility for the valuation of assets and liabilities measured at fair value requires that management obtain a sufficient understanding of the methods and significant assumptions employed by outside sources to derive fair value estimates. To estimate the fair value of investments, management may:

- Utilize information from third-party pricing sources.
- Gather data to develop its own estimate using various techniques, including models.
- Engage a specialist to develop an estimate.

Management often may use a combination of these approaches. For example, management may have its own pricing process, but use third-party pricing sources to corroborate its own values. Auditors will need to understand this process as well – including understanding the underlying source data for any methodologies utilized by management and/or its third party. So for example, if management takes the market value for its investments from the trustee statements at year-end, then management and, in turn, the auditor will need to understand how that trustee came to determine the fair value of the various type of investments held and reported. Some third parties will already include this methodology in their reports while others may be reluctant to tell you how they determined the fair value.

This becomes especially important to auditors as we can utilize our own third party pricing service in auditing the fair value, however we have to be careful that the underlying source data of our third party pricing service isn't the same underlying source data as management's pricing service, otherwise we are not independently auditing the information. If such source data is actual market data, then these sources can be the same between management and the auditor.

In the end, we will all need to <u>understand the methodology used to determine the fair value of each type of investment or asset and the source data that was utilized by that methodology.</u>

Acquisition Value

GASB 72 also utilizes the notion of acquisition value (as compared to fair value) for certain assets. Acquisition value can be thought of as an entrance price – contrasting to fair value being an exit price. It is defined as the price that would be paid to acquire an asset with equivalent service potential in an orderly market transaction at the acquisition date. The following assets should be measured at acquisition value:

- Donated capital assets.
- Donated works of art, historical treasures, and similar assets.
- Capital assets received in a service concession arrangement.

Donated capital assets were previously reported at fair value at the date donated, however, for all practical purposes, we were typically utilizing an entrance price (such as what it would have cost the government to construct a similar asset) to determine this fair value. As a result, we do not expect much change in the determination of this amount, however the valuation of donated capital assets is a disclosure in the accounting policies in almost every government's financial statements. Be sure that you <u>change the valuation methodology for donated capital assets from fair value to acquisition value</u>.

Transition

Most investments were previously measured at fair value and will continue to be, although some assets previously measured at fair value will now be measured at some other value. Restatement of the amounts that changed valuation methodologies is technically required, however restatement is not required if it is not practical to determine the new value retroactively. GASB 72 does say that use of acquisition value, such as for donated capital assets, should be applied prospectively to transactions occurring in the period GASB 72 is first applied.

Conclusion

There is a lot to consider for a standard that many of us originally may have considered to have included a few additional disclosure requirements. If you have any questions or if we can be of help to you in implementing GASB 72, please contact Joel Black, at jmblack@mjcpa.com.