May 19, 2016

OSRAP MEMORANDUM 16-20

TO: Fiscal Officers
All State Entities

FROM: Afranie Adomako, CPA
Director

SUBJECT: Implementation of Governmental Accounting Standards Board (GASB) Statement No. 72, Fair Value Measurement and Application (Effective FY 2016)

In February 2015, GASB issued Statement No. 72 (GASB 72), *Fair Value Measurement and Application*, designed to enhance the comparability of governmental financial statements by requiring fair value measurement for certain assets and liability using a consistent definition and accepted valuation techniques. GASB 72 amends the definitions of both fair value and investments as used throughout GASB literature, provides guidance for determining a fair value measurement for assets and liabilities required to be reported at fair value, provides guidance for applying fair value to certain investments, and provides additional disclosures for all fair value measurements.

GASB 72 redefines investments as securities or other assets that governments hold primarily for the purpose of income or profit having a present service capacity based solely on its ability to generate cash or to be sold to generate cash. According to GASB 72, the investment designation must be made when the asset is acquired and would remain over the life of the asset, even if the use of the asset changes over time. The expanded definition helps differentiate between portfolio-type investments and equity interests (such as interests in joint ventures or for-profit corporations) that enhance the government’s ability to provide services, which would not be considered investments and therefore not be subject to fair value measurement. By expanding how governments define investments, GASB 72 expands the scope of fair value reporting to include investments not previously reported at fair value including common stock. The GASB believes that all assets meeting the definition of an investment should be measured at fair value, except the following:
Nonparticipating interest earning investment contracts including non-negotiable certificates of deposit (cost-based measure)

Investments in unallocated insurance contracts (report as interest-earning investment contracts according to GASB Statement No. 31 or Statement No. 59)

Money market investments and participating interest-earning investment contracts that have remaining maturity at time of purchase of 3 months or less (amortized cost)

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

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

Fully benefit-responsive synthetic guaranteed investment contracts (contract value)

Investments in life insurance contracts not meeting the definition of a life settlement contract (cash surrender value)

Per GASB 72, investments in common stock, which were formerly valued using the cost method, must be measured at fair value unless the criteria as established in GASB Statement No. 62 (GASB 62) are met for the equity method. To further limit the use of the equity method, the GASB expanded the exclusions from using the equity method as prescribed in GASB 62 to include endowments (including permanent and term endowments, and permanent funds), investments using net asset value (ex: real estate funds, equity long/short hedge funds, and multi-strategy hedge funds) and investments in joint ventures or component units.

Prior to GASB 72, fair value was measured using the entry price or the price that would be paid to acquire an asset. GASB 72 defines fair value 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. The new definition focuses on market price from the perspective of a seller (exit price). Fair value measurement assumes transactions take place in the government’s principal market, or the government’s most advantageous market and that general market participants would act in their economic best interest. Fair value measurements should not be adjusted for transaction costs such as brokerage commissions. All assets requiring fair value measurement should be valued using the new exit price measurement with the exception of donated capital assets, donated works of art or historical treasures, and capital assets received in a service concession arrangement. These assets will continue to be measured using the entry price measurement, which is now considered acquisition value instead or fair value.

In addition to expanding the definitions of fair value and investments, the standard provides requirements for the valuation and disclosure of assets and liabilities reported at fair value. Governments are to use valuation techniques that are appropriate and for which sufficient data is available to measure assets and liabilities at fair value. These valuation techniques, which are inputs or data that market participants use in valuing assets and liabilities, should be applied consistently using one or more of the following approaches:

1. Market Approach – uses prices and other relevant information generated by market transactions involving identical or comparable assets, liabilities, or a group of assets or liabilities.
2. Cost Approach – reflects the amount that would be required to replace the present service capacity of an asset.
3. Income Approach – converts future amounts, such as cash flows or income and expenses to a single current, discounted amount.

Valuation techniques should be applied consistently from one accounting period to the next. However, a change in valuation techniques is appropriate if it provides a better representation of fair value. The change should be accounted for as a change in accounting estimate.

The GASB recognized the quality of the inputs or data used to determine fair value can vary depending on the source of the data. Some inputs are observable (quoted market prices) while others are unobservable (internally developed financial forecast). To help financial statement users better understand the quality of the inputs used in determining fair value, GASB Statement No. 72 establishes a three-tier fair value hierarchy that prioritizes the inputs based on relative reliability. Governments should review the inputs used in measuring all assets and liabilities valued at fair market value and categorize each using one of the three hierarchy levels:

1. Level 1 Inputs – quoted prices in active markets for identical assets or liabilities. Observable markets include exchange markets, dealer markets, brokered markets, and principal-to-principal markets.
2. Level 2 Inputs – inputs other than quoted prices included within Level 1 that are observable for the asset or liability. These inputs are derived from or corroborated by observable market data through correlation or by other means. Examples: Quoted prices for similar assets or liabilities in active or inactive markets, credit spreads, interest rates and yield curves observable at commonly quoted intervals.
3. Level 3 Inputs – unobservable inputs used only when relevant Level 1 and Level 2 inputs are unavailable. Examples: Nonbinding quotes on interest rate swaps that cannot be corroborated by observable market data and financial forecasts using internal data for commercial real estate.

GASB 72 requires governments to disclose the fair value hierarchy for each type of asset or liability measured at fair value in the notes to the financial statements. The standard also requires governments to disclose a description of the valuation techniques used in the fair value measurement and any significant changes in valuation techniques. The new disclosures are in addition to the disclosures currently required by GASB Statements No. 3, 31, 40, and 53 and should be organized by type of asset or liability instead of reporting entity segment.

GASB 72 is effective for periods beginning after June 15, 2015. The cash and investment note disclosure in the 2016 ISIS and Non-ISIS Annual Fiscal Report’s (AFR) and the Business-Type Activities (BTA) AFR Portal will be amended to capture the information required to be reported and disclosed under this statement. GASB 72 can be found on GASB’s website and you may contact Ms. Kimberly Dwin at (225) 219-4445 or via email at Kimberly.Dwin@la.gov with any questions.

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