March 2015

State Government Spotlight

GASB Issues Statement on Fair Value Measurement and Application

In This Issue:

The Bottom Line

- On February 27, 2015, the GASB issued Statement 72[1] (the "Statement") to enhance transparency and comparability of fair value measurements and disclosures in state and local governments' financial statements. The Statement establishes principles related to (1) the measurement of fair value and (2) the accounting for, and financial reporting of, assets and liabilities measured at fair value.
- A government is generally required to measure investments at fair value. Certain types of investments (e.g., money market investments and nonparticipating interest-earning contracts) are excluded from the Statement's guidance on fair value measurement and will continue to be measured in accordance with existing accounting standards.
- Under the Statement, fair value measurements are required for certain assets previously accounted for under the equity method, such as (1) investments in certain entities that calculate net asset value (NAV) per share (or its equivalent) and (2) common stock investments held by endowments. However, the Statement does not extend application of fair value measurements to other assets or liabilities not previously measured at fair value.
- The Statement permits a government to establish the fair value of certain investments that do not have a readily determinable fair value by using NAV per share (or its equivalent). However, investments measured in this manner should not be classified in the fair value hierarchy.
- Under the Statement, a government is required to measure at acquisition value (defined as a market-based entry price) certain assets previously measured at fair value. These assets include donated capital assets, donated works of art, historical treasures, and assets received by a government in a service concession arrangement.
- The Statement clarifies that fair value is a "market-based measurement" and "not an entity- or government-specific measurement." In addition, it establishes general principles for measuring fair value (e.g., it requires governments to (1) maximize the use of market-based inputs and

[1] GASB Statement No. 72, *Fair Value Measurement and Application.*

(2) use valuation techniques that are "appropriate under the circumstances and for which sufficient data are available to measure fair value").

- The new guidance requires additional disclosures about fair value measurements (i.e., disclosures about their level of classification in a hierarchy based on the relative reliability of inputs used to determine fair value).
- The Statement does not amend how changes in fair value are reported under paragraph 13 of Statement 31.[2]
- The Statement is effective for periods beginning after June 15, 2015, and should be applied retrospectively unless restatement of prior-period financial statements is not practical. Earlier application is encouraged.
- The new guidance is generally consistent with ASC 820.[3] However, it omits some limited detailed guidance that the GASB considered irrelevant to governments (e.g., the FASB's portfolio exception for derivatives).[4]

Beyond the Bottom Line

This *State Government Spotlight* discusses the Statement's (1) definition of fair value, (2) scope, (3) fair value measurement considerations, (4) disclosure requirements, and (5) effective date and transition. Illustrative disclosures from the Statement are reproduced in the Spotlight's appendix.

Clarified Definition of Fair Value

In a manner consistent with ASC 820, the Statement 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." It revises the existing definition of fair value in Statement 31 to emphasize that (1) fair value is a "market-based measurement" and "not an entity- or government-specific measurement" and (2) the sale of an asset or the transfer of a liability should be an orderly transaction and not a forced one. The Statement does not allow fair value to be adjusted for transaction costs.

Scope of the Statement

Governments are required to apply the Statement's guidance to assets and liabilities measured at fair value. In general,[5] an investment should be measured at fair value if it represents "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." The Statement specifically requires securitized debt obligations (i.e., "[l]oans acquired or originated by a government — such as mortgage loans acquired by a housing finance agency — that have been securitized") to be measured at fair value because the GASB "believes that fair value is the most relevant measure for these types of assets."

However, certain types of investments are excluded from measurement at fair value and will continue to be measured in accordance with existing accounting standards; such investments include money market investments, 2a7-like external investment pools, investments in life insurance contracts, common stock that qualifies for the equity method of accounting, unallocated insurance contracts, synthetic guaranteed investment contracts, and nonparticipating interest-earning investment contracts.

[2] GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*.

[3] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

[4] Under the exception in ASC 820-10-35-18D through 35-18H, an entity is not required to separately measure fair value for each financial unit of account (as defined by other guidance) if it manages a group of financial assets and financial liabilities (e.g., some derivative portfolios) on the basis of its net exposure to market or credit risks. The GASB concluded that this exception would not be applicable to governments because they do not offset long and short positions.

[5] That is, "provided that the investment's measurement is not specified in this Statement to be some other basis, such as contract value."

Thinking It Through

Governments will need to apply judgment in determining whether their assets and liabilities meet the definition of an investment. For example:

- A housing finance agency that made mortgage loans as part of a governmental program to encourage home ownership would not classify the loans as an investment because the present service capacity of the loans is to allow residents to purchase a home and is not based solely on the loan's ability to generate cash.
- A pension plan's life settlement contract held primarily for the purpose of profit (the proceeds received over the consideration paid) whose present service capacity is solely the contract's ability to generate cash would meet the definition of an investment.

In addition, a government should determine whether an asset meets the definition of an investment as of the date of acquisition and should not subsequently reclassify it as another asset type if the management intent changes (provided that the government still holds the asset). Further, a capital asset (e.g., a building, a vehicle, or equipment used in operations) held for sale should not be classified as an investment.

Certain Assets Measured at Acquisition Value

The GASB believes that measurement at acquisition value (i.e., an entry price measurement) is more appropriate for certain assets previously measured at fair value that would generally be used to provide services. These assets include (1) donated capital assets; (2) donated works of art, historical treasures, and similar assets; and (3) capital assets received in a service concession arrangement.

Investments in Entities That Calculate NAV per Share (or Its Equivalent)

Under the Statement, fair value measurements are required for investments in certain entities that calculate NAV per share (or its equivalent), which were previously accounted for under the equity method. A government is permitted in certain circumstances to determine the fair value of an investment in an entity that calculates NAV per share (or its equivalent) and does not have a readily determinable fair value (e.g., an investment in a hedge fund) by using the investment's NAV per share (or its equivalent). This practical expedient is consistent with the current practice of many governments.

Fair Value Measurement Considerations

Valuation Techniques

In measuring fair value, governments are required "to use valuation techniques that are appropriate under the circumstances and for which sufficient data are available to measure fair value." These techniques include the following approaches:

- *Market approach* — Under this approach, a government would use "prices and other relevant information generated by market transactions involving identical or similar assets, liabilities, or groups of assets and liabilities."
- *Cost approach* — This approach "reflects the amount that would be required currently to replace the present service capacity of an asset."
- *Income approach* — A government using this approach would convert "future amounts (for example, cash flows or revenues and expenses) to a single current amount (such as would be determined by using the discounted present value technique)."

Governments are required to apply their valuation techniques consistently. In certain circumstances, however, a change in the valuation technique may be appropriate, and such a change is accounted for as a change in accounting estimate.

Fair Value Measurement Hierarchy

The fair value hierarchy ranks the quality and reliability of inputs used to determine fair value. As noted in the Statement's Basis for Conclusions, existing guidance establishes two levels of inputs ("market-observed prices and those that are not"). The Statement, however, provides for three levels:

- *Level 1 inputs* — "Quoted prices (unadjusted) in active markets for identical assets or liabilities that a government can access at the measurement date."
- *Level 2 inputs* — "Inputs other than quoted prices included within Level 1 that are observable for an asset or liability, either directly or indirectly."
- *Level 3 inputs* — "Unobservable inputs for an asset or liability."

Under the Statement, governments are required to maximize observable or market-based inputs in measuring fair value because those are the most reliable valuation inputs. For example, if there is a quoted price in an active market for an identical asset or an identical liability (categorized in Level 1), a government should use that quoted price without adjustment when measuring fair value. Inputs based on unobservable data (Level 3) are the least reliable. A fair value measurement that includes inputs from more than one level is classified on the basis of the "lowest priority level input that is significant to the entire measurement" (e.g., "if there are three inputs significant to a certain fair value measurement, two of them are Level 2 inputs, and one is a Level 3 input, the fair value measurement would be categorized in Level 3 of the fair value hierarchy").

The table below provides examples of Level 1, Level 2, and Level 3 inputs:

Level and "Inputs" (Information Used to Measure Fair Value)	Examples
Level 1 — Quoted market prices for *identical* assets or liabilities in *active* markets	• Company A common stock traded and quoted on the New York Stock Exchange.
Level 2 — Observable market-based inputs other than Level 1 quoted prices; or market-corroborated inputs	• Company B common stock traded and quoted only on an inactive market in an emerging country. • A privately placed bond of Company B whose value is derived from a similar Company B bond that is publicly traded. • An over-the-counter interest rate swap that is valued on the basis of a model whose inputs are observable LIBOR[6] forward interest rate curves.
Level 3 — Unobservable inputs	• A long-dated commodity swap whose forward price curve, which is used in a valuation model, is not directly observable or correlated with observable market data. • Shares of a privately held company whose value is based on projected cash flows.

Disclosures

The fair value measurement hierarchy provides a basis for new disclosures that governments are required to make by type of asset or liability. The Statement requires the following disclosures for (1) assets and liabilities measured on a recurring basis (i.e., assets and liabilities measured at the end of each reporting period, such as an investment portfolio) and (2) assets and liabilities measured on a nonrecurring basis (such as an impaired capital asset that is held for sale):

a. For recurring and nonrecurring fair value measurements:

   (1) The fair value measurement at the end of the reporting period

   (2) Except for investments . . . that are measured at the NAV per share (or its equivalent), the level of the fair value hierarchy within which the fair value measurements are categorized in their entirety (Level 1, Level 2, or Level 3) [footnote omitted]

   (3) A description of the valuation techniques used in the fair value measurement

   (4) If there has been a change in valuation technique that has a significant impact on the result (for example, changing from an expected cash flow technique to a relief from royalty technique or the use of an additional valuation technique), that change and the reason(s) for making it.

b. For nonrecurring fair value measurements: the reason(s) for the measurement.

[6] London Interbank Offered Rate.

Thinking It Through

The disclosures listed above are in addition to the disclosures required by existing standards. For example, paragraph 15(a) of Statement 31 requires disclosure of the "methods and significant assumptions used to estimate the fair value of investments, if that fair value is based on other than quoted market prices." However, as noted above, the Statement introduced a third category of inputs (current requirements allow for only two levels, "market-observed prices and those that are not") to "provide sufficient distinction to reflect the qualitative differences among inputs without the categories becoming too narrow."

Further, the requirement to provide disclosures by type of asset or liability is in addition to the related guidance in Statement 40[7] that focuses on disaggregation by segment. Governments will need to consider various factors described in the Statement and use judgment in deciding the level of disaggregation to disclose by type of asset or liability. For example, a "type of asset or liability will often require greater disaggregation than the line items presented in the statement of net position"; and fair value measurements categorized in Level 3 of the fair value hierarchy may need to be disaggregated at a greater level since they are based on more subjective inputs. See the appendix for illustrative disclosures.

In addition, the Statement requires disclosures about investments in certain entities that calculate NAV per share (or its equivalent). However, the GASB decided that investments measured at NAV per share (or its equivalent) should **not** be categorized in the fair value hierarchy because such classification "would prove to be difficult and produce inconsistent disclosures." For related illustrative disclosures, see the appendix.

Thinking It Through

The GASB's decision noted above is consistent with the FASB's October 30, 2014, proposal to amend ASC 820 by eliminating the requirement to categorize in the fair value hierarchy investments for which entities use NAV per share (or its equivalent) as a practical expedient.

Effective Date and Transition

The Statement is effective for periods beginning after June 15, 2015. Earlier application is encouraged. In the period of adoption, governments are required to adjust prior periods for the effect of initial application and restate financial statements for all affected prior periods presented.

However, if restatement of the financial statements is not practical, governments should recognize the cumulative effect of applying the Statement as an adjustment to the beginning net position (or fund balance or fund net position, as appropriate) for the earliest period presented and describe the reasons for not restating prior periods.

[7] GASB Statement No. 40, *Deposit and Investment Risk Disclosures* — an amendment of GASB Statement No. 3.

Appendix — Illustrative Disclosures

The example below, which is reproduced from Statement 72, illustrates some of the fair value disclosures required under the GASB's new guidance.

Example 2 — Defined Benefit Pension Plan

Facts and Assumptions

A retiree pension defined benefit plan holds significant amounts of investments that are measured at fair value on a recurring basis. Because investing is a key part of the plan's activities, the plan shows greater disaggregation in its disclosures. The plan chooses a tabular format for disclosing the levels within the fair value hierarchy. All of the derivative instruments are investments, not hedging derivative instruments.

Illustrative Disclosure

The Plan categorizes its fair value measurements within the fair value hierarchy established by generally accepted accounting principles. The Plan has the following recurring fair value measurements as of December 31, 20X1:

Investments and Derivative Instruments Measured at Fair Value ($ in millions)		**Fair Value Measurements Using**		
	12/31/X1	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Investments by fair value level				
Debt securities				
U.S. Treasury securities	$ 85	$ 85		
Commercial mortgage-backed securities	50		$ 45	$ 5
Collateralized debt obligations	30		5	25
Residential mortgage-backed securities	149		24	125
Corporate bonds	93	9	84	
Total debt securities	407	94	158	155
Equity securities				
Financial services industry	150	150		
Healthcare industry	110	110		
Other	15	15		
Total equity securities	275	275		
Venture capital investments				
Direct venture capital — healthcare	53			53
Direct venture capital — energy	32			32
Total venture capital investments	85			85
Private equity funds — international	43			43
Total investments by fair value level	810	$ 369	$ 158	$ 283

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	12/31/X1	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Investments measured at the net asset value (NAV)				
Equity long/short hedge funds	55			
Event-driven hedge funds	45			
Global opportunities hedge funds	35			
Multi-strategy hedge funds	40			
Real estate funds	47			
Total investments measured at the NAV	222			
Total investments measured at fair value	$1,032			
Investment derivative instruments				
Interest rate swaps	$ 57		$ 57	
Foreign exchange contracts (liabilities)	(43)		(43)	
Total investment derivative instruments	$ 14		$ 14	

Debt and equity securities classified in Level 1 of the fair value hierarchy are valued using prices quoted in active markets for those securities. Debt securities classified in Level 2 of the fair value hierarchy are valued using a matrix pricing technique. Matrix pricing is used to value securities based on the securities' relationship to benchmark quoted prices. Commercial and residential mortgage-backed securities classified in Level 3 are valued using discounted cash flow techniques. Collateralized debt obligations classified in Level 3 are valued using consensus pricing.

Venture capital investments classified in Level 3 are valued using either a discounted cash flow or market comparable companies technique.

Private equity funds — international are valued as described in the following schedule, Note 6.

The valuation method for investments measured at the net asset value (NAV) per share (or its equivalent) is presented on the following table.

Derivative instruments classified in Level 2 of the fair value hierarchy are valued using a market approach that considers benchmark interest rates and foreign exchange rates.

Investments Measured at the NAV
($ in millions)

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

1 *Equity long/short hedge funds.* This type includes investments in 12 hedge funds that invest both long and short primarily in U.S. common stocks. Management of each hedge fund has the ability to shift investments from value to growth strategies, from small to large capitalization stocks, and from a net long position to a net short position. The fair values of the investments in this type have been determined using the NAV per share of the investments. Investments representing approximately 22 percent of the value of the investments in this type cannot be redeemed because the investments include restrictions that do not allow for redemption in the first 12 to 18 months after acquisition. The remaining restriction period for these investments ranged from three to seven months at December 31, 20X1.

2 *Event-driven hedge funds.* This type includes 3 investments in hedge funds that invest in approximately 60 percent equities and 40 percent bonds to profit from economic, political, corporate, and government-driven events. A majority of the investments are targeted at economic policy decisions. The fair values of the investments in this type have been determined using the NAV per share (or its equivalent) of the investments.

3 *Global opportunities hedge.* This type includes investments in 5 hedge funds that hold approximately 80 percent of the funds' investments in non-U.S. common stocks in the healthcare, energy, information technology, utilities, and telecommunications sectors and approximately 20 percent of the funds' investments in diversified currencies. The fair values of the investments in this type have been determined using the NAV per share (or its equivalent) of the investments. For one investment, valued at $8.75 million, a gate has been imposed by the hedge fund manager, and no redemptions are currently permitted. This redemption restriction has been in place for six months, and the time at which the redemption restriction might lapse cannot be determined.

4 *Multi-strategy hedge funds.* This type invests in 15 hedge funds that pursue multiple strategies to diversify risks and reduce volatility. The hedge funds' composite portfolio for this type includes investments in approximately 50 percent U.S. common stocks, 30 percent global real estate projects, and 20 percent arbitrage investments. The fair values of the investments in this type have been determined using the NAV per share (or its equivalent) of the investments. Investments representing approximately 15 percent of the value of the investments in this type cannot be redeemed because the investments include restrictions that do not allow for redemption in the first year after acquisition. The remaining restriction period for these investments ranged from four to six months at December 31, 20X1.

5 *Real estate funds.* This type includes nine real estate funds that invest primarily in U.S. commercial real estate. The fair values of the investments in this type have been determined using the NAV per share (or its equivalent) of the Plan's ownership interest in partners' capital. These investments can never be redeemed with the funds. Distributions from each fund will be received as the underlying investments of the funds are liquidated. It is expected that the underlying assets of the funds will be liquidated over the next 7 to 10 years. Twenty percent of the total investment in this type is expected to be sold. However, the individual investments that will be sold have not yet been determined. Because it is not probable that any individual investment will be sold, the fair value of each individual investment has been determined using the NAV per share (or its equivalent) of the Plan's ownership interest in partners' capital. Once it has been determined which investments will be sold and whether those investments will be sold individually or in a group, the investments will be sold in an auction process. The investee fund's management is required to approve of the buyer before the sale of the investments can be completed.

6 *Private equity funds — international.* This type includes two private equity funds that invest primarily in foreign technology companies. These investments can never be redeemed with the funds. Instead, the nature of the investments in this type is that distributions are received through the liquidation of the underlying assets of the fund. If these investments were held, it is expected that the underlying assets of the fund would be liquidated over five to eight years. However, as of December 31, 20X1, it is probable that all of the investments in this type will be sold at an amount different from the NAV per share (or its equivalent) of the Plan's ownership interest in partners' capital. Therefore, the fair values of the investments in this type have been determined using recent observable transaction information for similar investments and nonbinding bids received from potential buyers of the investments. As of December 31, 20X1, a buyer (or buyers) for these investments has not yet been identified. Once a buyer has been identified, the investee fund's management is required to approve of the buyer before the sale of the investments can be completed.

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