NORTH CAROLINA
DEPARTMENT OF STATE TREASURER
STATE AND LOCAL GOVERNMENT FINANCE DIVISION
AND THE LOCAL GOVERNMENT COMMISSION

JANET COWELL
TREASURER

GREGORY C. GASKINS
DEPUTY TREASURER

Memorandum #2016-05

TO: **Local Government Finance Officials and Their Independent Auditors**

FROM: **Sharon Edmundson, Director, Fiscal Management Section**

SUBJECT: **GASB Statement 72, Fair Value Measurement and Application**

DATE: **October 1, 2015**

The Governmental Accounting Standards Board (GASB) issued *Statement 72, Fair Value Measurement and Application* (GASBS 72) in February 2015. After a review of existing standards the GASB found opportunities to improve the measurement of resources available to governments and to increase consistency, comparability and transparency. Its intention is to be more consistent with the definition / accounting standards of fair value measurements issued by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB). The statement will guide governments in determining a fair value measurement for financial reporting purposes and applying fair value to certain investments. GASBS 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*." Fair value is an *exit price* based on a government's principal or most advantageous market. The requirements of this statement are effective for financial statements for periods beginning after June 15, 2015 (June 30, 2016 fiscal year end for most of our local governments). This memo summarizes GASBS 72 focusing on the statement's applicability and generally minimal impact on local governments and public authorities in North Carolina.

GASBS 72 will require certain *investments* to be measured at fair value. This Statement requires fair value measurements for certain investments **not previously measured at fair value**. It does not extend the application of fair value measurements to other assets or liabilities that previously were not measured at fair value. An investment is defined 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. Local government and public authority capital assets used for operations do not meet the definition of an investment and therefore are excluded from the requirement for use of fair value measurement. The initial determination of whether an asset or liability meets the definition of an investment is made at the time of the asset or liability's acquisition and cannot be changed later.

Assets or liabilities that meet the definition of an investment that generally should be measured at fair value:

- Alternative investments such as private equity, hedge funds, etc.
- Equity securities, stock warrants, and stock rights that do not have readily determinable fair values
    - Provided such investment-types are not reported according to the equity method
- Commingled investment pools that are not government sponsored
- Invested securities lending collateral
- NC Capital Management Trust Term Portfolio
- Non-money market debt securities

If the following assets meet the definition of an investment, they also should be measured at fair value

- Intangible assets
- Land and land rights
- Real estate
- Lending assets
- Natural resource assets

Prior to the effective date or implementation of GASBS 72, the following assets were required to be measured at fair value. When a unit acquires the following assets during fiscal years beginning after June 15, 2015, it will now be required to measure these assets at acquisition value (market-based entry price):

- Donated capital assets
- Donated works of art, historical treasures, and similar assets
- Capital assets acquired through a non-exchange transaction
- Capital assets received in a service concession arrangement

Acquisition value 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, or the amount at which a liability could be liquidated with the counterparty at the acquisition date*." The price would be adjusted for transportation costs, but would not otherwise be adjusted for transaction costs.

Example: Donated capital assets. A contract between the City of Dogwood and the developer of a new subdivision states that the City will agree to maintain the streets and the water / sewer infrastructure of a new subdivision upon completion. When the developer donates these assets to the City, the engineer for the subdivision project provides the monetary value of the streets and new infrastructure (including curbs, gutters, storm sewers, land, right of way, easements etc…) to the City. This acquisition value provided by the engineer is based on bids and recent comparable projects.

Under the GASBs former guidance and also under GASBS 72 there are exemptions for some investments. Investments **not measured at fair value** will continue to include:

- Money market investments and participating interest-earning investment contracts that have a maturity at time of purchase of one year or less, reported by governments other than external investment pools. They should be measured at amortized cost.
- 2a7 or 2a7-like external investment pools. They should be measured at amortized cost.
    - NC Capital Management Trust Cash Portfolio is a 2a7 fund.
- Investments in life insurance. Investments in life settlement contracts however, should be at fair value.
- Common stock meeting the criteria for applying the equity method
    - Investments in common stock held by endowments as well as investments in certain entities that calculate net asset value per share are ineligible for the equity method.
- Unallocated insurance contracts, and
- Synthetic guaranteed investment contracts that are fully benefit responsive.
- Non-participating "interest earning" contracts (bank deposits and repos in NC). They should be measured at amortized cost.

There will be no change to the current fair value measurement requirements of investments allowable under G.S. 159-30; however, local governments and public authorities that have expanded investment authority granted through legislation may have assets and/or liabilities that meet the definition of an investment as defined by GASBS 72. Entities that administer retirement systems other than the Law Enforcement Special Separation Allowance may be impacted by GASBS 72. These local governments and public authorities will be required to use valuation techniques that are appropriate under the circumstances to determine the expected price their assets or liabilities would bring in current market conditions for which sufficient data are available to measure fair value. Simply stated - how much the investment/asset would sell for or how much it would cost to dispose of a liability with a market participant as of the measurement date. The techniques should be consistent with one or more of three approaches, applied consistently, to maximize the use of relevant observable inputs, and to minimize the use of unobservable inputs.

- The market approach - uses prices and other relevant information generated by market transactions involving identical or comparable assets, liabilities, or a group of assets and liabilities.
- The cost approach - reflects the amount that would be required to replace the present service capacity of an asset.
- The income approach converts future amounts (such as cash flows or income and expenses) to a single current (discounted) amount through use of management judgment.

Valuation techniques used are to be consistently from period to period; however, a change in a valuation technique could be appropriate if the change results in a measurement that is more representative of fair value. Changes in valuation techniques applicable to assets or liabilities should be accounted for as a change in accounting estimate and disclosed accordingly.

This Statement establishes a hierarchy of three levels of inputs to the valuation techniques that are used to measure fair value.

- Level 1 inputs are directly observable, quoted prices (unadjusted) in active markets for identical assets or liabilities.
- Level 2 inputs are inputs—other than quoted prices—included within Level 1 that are either directly or indirectly observable for the asset or liability.
- Level 3 inputs are unobservable inputs, such as management's assumption of the default rate among underlying mortgages of a mortgage-backed security. Use Level 3 only if Level 1 and Level 2 inputs are not available.

When fair value measurements are used in determining the amounts recognized in the financial statements, this statement requires additional disclosures to be made in the notes about fair value measurements, the level of fair value hierarchy, and valuation techniques. Governments should organize these disclosures by type of asset or liability reported at fair value. The Statement also requires additional disclosures regarding investments in certain entities that calculate net asset value per share (or its equivalent). The required disclosures in Statements 3, 40 and 53 regarding credit risk, custodial credit risk, and interest rate risk remain unchanged.

If restatement of the financial statements for all prior periods presented in the audit is not practical, the cumulative effect of applying this statement, if any, should be reported as a restatement of beginning net position (or fund balance) for the earliest period presented. Governmental units that sell General Obligation bonds may be required to adjust prior year items when we prepare the official statement for the bond sale.

You can access GASBS 72 and all GASB statements free of charge at www.gasb.org. If you have any questions, please contact Becky Dzingeleski, becky.dzingeleski@nctreasurer.com (919) 814-4287.