GASB GOVERNMENTAL ACCOUNTING STANDARDS BOARD

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THE GASB'S FAIR VALUE PROPOSALS: WHAT FINANCIAL STATEMENT USERS NEED TO KNOW

In May 2014, the Governmental Accounting Standards Board (GASB) proposed new accounting and financial reporting standards related to fair value. The "Exposure Draft" proposes how fair value should be measured, which types of assets and liabilities should be measured at fair value, and what note disclosures should be provided with fair value measures.

This article summarizes in plain language the major provisions of the GASB's fair value proposals. It is intended for people who use financial information about governments to make decisions, perform analyses, or hold governments accountable—such as municipal bond analysts at rating agencies and mutual funds, legislators and legislative staff at various levels of government, members of oversight bodies, and staff at citizen groups and taxpayer associations. The article concludes with information about how you can give the GASB feedback on its fair value proposals and thereby assist the GASB in finalizing the standards.

This article is organized into four parts. Each addresses a major aspect of the GASB's proposals—how fair value should be defined, how it should be measured, which assets and liabilities it should be applied to, and what information about fair value should be disclosed in the notes to the financial statements.

Definition of Fair Value

Fair value has been used for many years in governmental accounting to measure most investments and some other assets. The proposed definition of fair value is fundamentally consistent with the definition upon which the GASB's existing fair value standards are based. However, the proposed definition is more precise in its terminology and is more extensively explained:

> Fair value is 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.

This definition is more specific than the one found in GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools:* “The amount at which a financial instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale” (paragraph 22). The change in language to “an orderly transaction between market participants” is intended to emphasize the GASB’s view that fair value is market based, not specific to a particular government. In other words, fair value should be objectively based on market conditions and relevant factors. The market to which the proposed definition refers is a government’s principal market or, when there is not a principal market, the government’s most advantageous market.

Another notable change in the proposed definition is the focus on a price to *sell* an asset or *transfer* a liability, rather than on an exchange. The proposed definition emphasizes that fair value is an *exit price*, whereas the existing definition is unclear as to whether fair value is a seller’s price or a buyer’s price, which sometimes may be significantly different. The use of “measurement date” in the new definition also is more precise than “current” in the existing definition. The initial measurement date is the date of the transaction, and subsequent measurement dates are the dates of the financial statements in which the fair value is reported.

How Fair Value Would Be Measured

The GASB is proposing three acceptable “valuation approaches” to measuring fair value—market, cost, or income.

- Determining fair value with the “market approach” utilizes information resulting from market transactions for identical or similar assets or liabilities.
- The “cost approach,” on the other hand, bases fair value on the amount necessary to replace an asset’s present capacity for providing service.
- The “income approach” calculates fair value by converting future amounts to a single current amount. For instance, a government might project cash flows from an asset and discount them to their present value.

Depending on the asset or liability in question, a government could establish fair value by employing any of a variety of “valuation techniques” that are consistent with one or more of these approaches. If market information that qualifies as a Level 1 input (see below) is available for measuring fair value, a government would employ valuations techniques consistent with the market approach rather than the cost or income approaches. Any valuation technique should be based on “observable inputs” as much as possible.

Hierarchy of Fair Value Inputs

Inputs are the assumptions that market participants make when deciding on the price for an asset or liability, such as the degree of risk they perceive. Observable inputs are those that are readily accessible to the public, such as available market data based on actual transactions, whereas “unobservable inputs” are not.

The GASB is proposing a three-level hierarchy of inputs into the measurement of fair value. Level 1 and Level 2 inputs are observable and Level 3 inputs are unobservable. (This hierarchy has been in use in the private sector since 2006 under the standards of the Financial Accounting Standards Board.)

- Level 1 inputs are quoted prices from markets with many transactions for *identical* assets and liabilities. Level 1 inputs are derived directly from the market and need not be adjusted in any way.
- Level 2 inputs are either (a) directly observable, like quoted market prices, but for *similar* assets and liabilities, or (b) correlated or corroborated from observable market information. Generally, Level 2 inputs should not be used unless Level 1 inputs are unavailable.
- Level 3 inputs are assumptions a government develops based on the best information available to it. Generally, Level 3 inputs should not be used unless Level 1 and Level 2 inputs are unavailable.

The distinction between the three levels speaks to the reliability of the measurement of an asset or liability's fair value. Observable inputs are innately more reliable than unobservable inputs because observable inputs are easier to verify. Level 1 inputs generally are more reliable than Level 2 inputs because Level 1 inputs are drawn directly from active markets without adjustment. However, if Level 1 inputs are based on transactions that are not orderly, Level 2 inputs may be more reliable in those circumstances.

Factors Affecting the Measurement of Fair Value

In many cases, fair value is based on Level 1 inputs such as quoted prices or actual transaction amounts. The acceptance of such information as accurate measures of the fair value of an asset or liability is based, in part, on the knowledge that the information comes from markets with many transactions that are conducted in an orderly fashion between willing participants. What happens, though, if these conditions are not met?

The GASB proposal addresses certain circumstances in which a government may need to consider adjusting quoted prices or transaction amounts to arrive at fair value. For instance, a significant decline in the number of transactions for an asset or liability or in the dollar amounts involved could indicate that the quoted prices are not an accurate measure of fair value. The future cash flows related to such assets or liabilities would be inherently more uncertain than if the market were robust. The quoted prices may need to be adjusted to incorporate a premium that compensates for greater risk.

Likewise, adjustments may be needed to establish fair value when markets are not orderly. The presumption of willing parties to a transaction may not be appropriate, for example, if the seller or buyer is under fiscal duress. A need to obtain cash may impel a government to accept a price to sell an asset or transfer a liability that it otherwise would not accept if it were not forced to do so. These circumstances, too, would require a government to use its professional judgment to determine what adjustments to prices or transaction amounts need to be made to arrive at fair value.

How Fair Value Would Be Applied to Assets and Liabilities

The GASB is proposing that investments generally should be measured at fair value. Fair value is well suited for assessing a government's financial position. At present, most investments already are required to be reported at their fair value in the financial statements of state and local governments.

To distinguish which assets are investments and, therefore, should be reported at their fair values, the GASB is proposing the following definition of an investment:

> An investment is a security or other asset (a) that a government holds primarily for the purpose of income or profit and (b) with present service capacity that is based solely on its ability to generate cash or to be sold to generate cash.

The proposed definition expressly excludes capital assets held for resale.

The principal implication of this proposed definition is that some items not commonly reported as investments at present would henceforth be considered investments and therefore governments would have to measure their fair values. It also is possible that some assets governments are currently reporting as investments would no longer be considered investments. For example, housing finance agencies and institutions of higher education may report as investments mortgage and student loans, respectively. Because such loans are associated with government programs (financing certain home buyers and supporting education, respectively), the loans would not be classified as investments and not measured at fair value.

Alternative Investments

Some governmental entities—particularly pension funds and endowments—hold investments for which they may not be able to readily determine fair value. These investments in entities that calculate net asset value per share—sometimes called "alternative investments"—frequently take the form of shares in hedge funds and limited partnerships. It is difficult to measure their fair value because their shares are not traded openly or the ability to sell shares is limited to a degree that there are few or no observable inputs. The question arises, "How does a government place a fair value on such investments for financial reporting purposes?

The GASB is proposing that governments in these circumstances should be allowed to value their investment using "net asset value per share" (or its equivalent). Net asset value per share is an amount provided by a hedge fund, for instance, based on its measurement of the fair value of its assets and liabilities. It essentially equals assets minus liabilities (net assets) divided by the total number of shares in the fund. Multiplied by the number of shares a government owns, it produces a value for the government's investment that can be reported in its financial statements.

Exceptions to Fair Value

Under existing standards, several types of investments are not required to be reported at fair value. The GASB is proposing that the following exceptions to the requirement to measure investments at fair value should be continued:

- Investments with a maturity of one year or less at the time of purchase, such as money market investments
- Investments in 2a7-like external investment pools (a type of government-sponsored, short-term investment pool)
- Most investments in life insurance
- Investments in common stock that meet the criteria for applying the equity method of accounting (briefly, an investment in voting stock that gives a government the ability to exercise significant influence over the company's operating and financial policies)
- Non-participating interest-earning investment contracts (those with redemption terms that are not affected by market rates, such as a typical certificate of deposit)
- Unallocated insurance contracts (a type of investment that pension plans enter into with insurance companies)
- Synthetic guaranteed investment contracts that are fully benefit responsive (an explanation of the meaning of "fully benefit responsive" can be found in paragraph 67 of Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*).

Use of Acquisition Value

Fair value is an exit price—the price a government would receive if it sold an asset. Acquisition value, on the other hand, is an entry price—the price that would have to be paid to acquire a similar asset with similar service capacity. Acquisition value is a replacement cost measurement attribute. The GASB's view is that certain assets currently required to be measured at fair value should be measured at acquisition value instead:

- Donated capital assets
- Donated works of art and historical treasures
- Capital assets received in a service concession arrangement (an arrangement in which (1) a government conveys to another entity the right and related obligation to provide services through the use of infrastructure or another public asset in exchange for significant consideration and (2) the entity collects and is compensated by fees from third parties).

How Fair Value Would Be Disclosed

As described earlier, the reliability of inputs that a government employs when measuring fair value may vary considerably. Level 1 inputs are more reliable than Level 2 inputs, which in turn are more reliable than Level 3 inputs. It is important for users to understand and use fair value information with some level of assurance that the amounts faithfully represent the value of a government's assets and liabilities. The

GASB believes that achieving that level of comfort requires governments to disclose in the notes to the financial statements the methods and assumptions they employ when measuring fair value.

Level of Detail for Disclosures

The GASB is proposing that fair value disclosures should be organized by type or class of asset and liability. In other words, it would not be sufficient in general for a government to simply disclose its investments in the aggregate. The extent to which those types or classes are disaggregated, though, depends on a variety of factors, such as:

- The nature, characteristics, and risks of the assets or liabilities (for instance, investments in corporate stock would be disclosed separately from commercial paper)
- Which level of inputs are used to measure the fair value of the assets or liabilities (there would be greater disaggregation for assets and liabilities measured using Level 3 inputs)
- If standards specifically require separate disclosure of an asset or liability (such as derivatives)
- The value of the assets or liabilities measured at fair value relative to all assets and liabilities.

Proposed Disclosures

Under current accounting standards, governments are required to disclose how they arrived at their measures of fair value if they are not based on quoted market prices. The GASB is proposing a more detailed set of disclosures that take into account the levels of inputs a government uses to measure fair value and their inherent degrees of uncertainty and subjectivity. Governments would disclose the following:

- The fair value amounts as of the date of the financial statements, and the levels of inputs used to determine them
- The valuation techniques and inputs used
- Any changes in techniques and inputs that had a significant impact on the measurement of fair value and the reasons for the changes
- For fair value measurements categorized in Level 3 (other than alternative investments), the effect of those investments on investment income for the reporting period.

The additional disclosure when Level 3 inputs are used is important because they are unobservable and, consequently, more difficult for a user to objectively verify.

The GASB is proposing additional disclosures for alternative investments. As described earlier, these investments do not have a readily determinable fair value and, therefore, the GASB believes governments should be able to use net asset value per share to value them. However, net asset value per share is often more uncertain and subjective than the fair value measurements of other assets and liabilities.

Governments with alternative investments would disclose the following for each type of alternative investment:

- Fair value amounts as of the date of the financial statements
- Significant investment strategies of the entities in which the government has invested
- When the entities are expected to liquidate the assets underlying the investment
- The amount of any related commitments the government has, for which it has not set aside resources (unfunded commitments)
- Terms and conditions under which the government may redeem the investments
- Restrictions preventing the government from redeeming an investment that otherwise is redeemable, and when the restriction is expected to end. (If the government does not know when the restriction will end, it should disclose that fact and state how long the restriction has been in effect.)
- Other significant restrictions on the government's ability to sell the investments.

WHAT COMES NEXT?

When the GASB sets standards, a crucial part of its "due process" activities is the publication of documents for public discussion and comment. As a user of governmental financial information, you can help the GASB to complete this project by reviewing the proposals and letting the GASB know if the information that governments would provide under the proposed standards would be valuable to the work you do, the decisions you make, or the analyses that you perform.

The GASB is conducting a brief survey of users of governmental financial information like you, which can be found at http://bit.ly/1wQLRTu. The survey results will be shared with the GASB members and considered as part of their deliberations.

If you would like to submit written comments to the GASB, there are two ways you may do so:

- By email—send your comments to director@gasb.org
- By traditional mail—include your comments in a letter and mail to:

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Comments are requested by August 15, 2014.