

Accounting and Financial Reporting for Cash and Investments

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GASB Statement No. 31 Specific Reporting Requirements

- Some provisions replaced by GASB Statement No. 72
- External investment pools
 - Now mainly addressed by GASB Statement No. 79
 - Debt securities with remaining maturity of 90 days or less from the balance sheet date – cost / amortized cost
 - Pools with legally binding share guarantees (STIF)
- Changes in fair value reported when they occur
- NO separation of realized vs. unrealized
 - Exception for external investment pools
 - Separate note disclosure allowed for both
- Operating statement implications

GASB Statement No. 31 Required Note Disclosures

- Definitions of realized vs. unrealized gains/losses
- Income from one fund assigned to another
- Amortized cost option

GASB Statement 72

Fair Value Measurement and
Application

Overview

- **What:** The GASB issued Statement 72 to update the existing standards on fair value (primarily Statement 31)
- **Why:** Review of existing standards found opportunities to improve the measurement of resources available to governments, and to increase comparability and accountability
- **When:** Effective for fiscal years beginning after June 15, 2015

Fair Value Definition

- 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.
 - An exit price
- Other characteristics of fair value
 - Market-based
 - Based on a government's principal or most advantageous market
- Fair value is not an option – it is required

Valuation Techniques

- Apply valuation technique(s) that are appropriate in the circumstances
 - **Market approach** – Using prices and other relevant information generated by market transactions involving identical or similar assets or liabilities
 - **Cost approach** – Amount that would be required currently to replace the service capacity of an asset
 - **Income approach** – Converts expected future amounts (for example, cash flows) to a single current amount (that is, discounted)
- Revisions due to a change in valuation technique(s) are considered a change in accounting estimate

Inputs

- Maximize use of relevant observable inputs and minimize use of unobservable inputs
- Inputs should be consistent with the characteristics of the asset or liability
- Based on bid and ask prices
- **Level 1:** quoted prices (unadjusted) in active markets for identical assets or liabilities, most reliable
- **Level 2:** quoted prices for similar assets or liabilities, quoted prices for identical or similar assets or liabilities in markets that are not active, other than quoted prices that are observable, or market-corroborated inputs
- **Level 3:** unobservable inputs (would include market participant assumptions and management estimates), least reliable

Investment Definition

- A security or other asset that a government holds primarily for the purpose of income or profit and with a present service capacity that is based solely on its ability to generate cash or to be sold to generate cash
 - Service capacity refers to a government's mission to provide services
 - Held primarily for income or profit—acquired first and foremost for future income and profit

Fair Value Application

- Assets that meet the definition of an investment generally should be measured at fair value (some examples follow)
 - Alternative investments
 - 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
 - Debt securities
 - Open-end mutual funds
 - Interest-earning investment contracts
 - External investment pools

Investments Not Reported at Fair Value

- Money market investments and participating interest-earning investment contracts that have a remaining maturity at time of purchase of one year or less, reported by governments other than external investment pools – option of amortized cost
- Investments in 2a7-like pools – net asset value per share
- Investments in life insurance - investments in life settlement contracts, however, should be at fair value
- Investments in common stock that meet the criteria for applying the equity method
- Non-participating interest-earning investment contracts
- Unallocated insurance contracts
- Synthetic guaranteed investment contracts that are fully benefit responsive

Disclosures

- The following information for each class or type of assets and/or liabilities measured at fair value should be disclosed:
 - The fair value measurement at the end of the reporting period and for nonrecurring fair value measurements, the reasons for the measurement
 - 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 technique(s)
 - Changes in valuation techniques
- Disclosures for investments in certain entities that calculate NAV per share (or its equivalent)
 - Information that helps users of its financial statements to understand the nature and risks of the investments
 - Information on whether the investments are probable of being sold at amounts different from net asset value per share (or its equivalent)

GASB 40 – Deposit/Investment Risk Disclosures

- Modifications of GASB Statement No. 3:
 - Custodial credit risk disclosures for deposits and investments for Categories 1 and 2 eliminated
 - Only Category 3 disclosures required – uninsured and uncollateralized deposits / investments that are uninsured, unregistered or held by counterparty or counterparty's agent, but not in government's name
 - Window-dressing disclosures eliminated
 - Definition of counterparty changed – party that pledges securities or collateral or buys or sells securities from government

GASB 40–Deposit/Investment Risk Disclosures (Cont.)

- Investment disclosures should be aggregated by investment type – do not aggregate dissimilar items – consider risk profiles of investments
- Disclosure level is usually for the primary government (PG)
- Added disclosure if risks are greater for business-type activities, governmental activities, major funds, aggregate nonmajor funds, etc., than for PG as a whole

GASB 40–Deposit/Investment Risk Disclosures (Cont.)

- Disclosures for Component Units may be necessary – follow GASB Statement No. 14 requirements (as amended)
- Disclosures may be made by portfolio

GASB 40–Deposit/Investment Risk Disclosures (Cont.)

- Disclosures should be made for deposit & investment policies related to risks in GASB 40
 - Do not reprint entire policy – summarize
 - Disclosure only for risks government is exposed to
 - If no policy for a risk – disclose this fact
 - No change in requirement to disclose legally authorized investments, even if policy is more restrictive
 - Should be a formally adopted policy – usually by governing board – for informal practices, disclose that there is no policy

GASB 40–Deposit/Investment Risk Disclosures (Cont.)

- Disclosures for specific risks - credit risks
 - Disclose credit rating or that investment is unrated
 - If split ratings - disclose
 - Does not apply to US government or explicitly guaranteed investments
 - Does apply to implicit guarantees (Fannie Mae, Freddie Mac)
 - Disclose pool ratings, not underlying investments (NCCMT Government – AAAM-rated; Term & STIF– unrated)
 - Investments may be aggregated by rating categories
 - If security is unrated, but issuer is rated – no rating

GASB 40–Deposit/Investment Risk Disclosures (Cont.)

- Disclosures for specific risks - custodial credit risks – previously discussed
 - Disclose amounts at risk from Category 3 and how at risk
 - Discussion of categories of risk omitted
 - Disclosure not required for investment pools and mutual funds
 - Disclosure required for unsecured portion of repurchase agreements

GASB 40–Deposit/Investment Risk Disclosures (Cont.)

- Disclosures for specific risks - concentration of credit risk
 - Disclose by amount & issuer investments in any one issuer of 5% or more of total *investments* (not including deposits) based on level of detail discussed previously
 - US treasuries & US government-guaranteed investments are excluded from this requirement
 - Investments in mutual funds (NCCMT) and investment pools (STIF) are excluded from this requirement
 - Repurchase agreements – underlying collateral – if US government-guaranteed, no disclosure

GASB 40–Deposit/Investment Risk Disclosures (Cont.)

- Disclosures for specific risks - Foreign currency risk
 - Not normally applicable in NC
 - Eurodollar CD's

GASB 40–Deposit/Investment Risk Disclosures (Cont.)

- Disclosures for specific risks - interest rate risk
 - Disclose information by investment type using 1 of 5 methods
 - Segmented time distribution
 - Specific identification
 - Weighted average maturity
 - Duration
 - Simulation model
 - Use method closest to how risk is managed
 - Disclose assumptions about timing of cash flows (calls), interest rates, etc.
 - Not required for deposits and NCCMT Government Portfolio

GASB 40–Deposit/Investment Risk Disclosures (Cont.)

- Disclosures for specific risks - interest rate risk (cont.)
 - Interest rate disclosure methods may be changed – change in accounting principle
 - Separate methods may be used for short & long-term investments
 - For variable rate investments the maturity is the next reset date
 - Weighted average maturity disclosed for STIF & Term Portfolio

GASB 40–Deposit/Investment Risk Disclosures (Cont.)

- Disclosures for specific risks (cont.):
 - Disclose for investments with fair values that are highly subject to changes in interest rates
 - Terms not otherwise disclosed – imbedded options, coupon multipliers, reset dates, etc.
 - Disclosures for examples may be aggregated
- Numerous examples given in statement
- No disclosures required for legal, liquidity, and inflation risks

Policy Disclosures

- Authorized investments
- Statutory noncompliance
- Cash and cash equivalents
- Discretely presented component unit considerations
 - Disclosures made when material to primary government
 - Must be distinguished from the primary government
- Cash flow statement reconciliation to balance sheet NOT appropriate for notes

GASB 53 – Accounting and Financial Reporting for Derivatives

- Expands on existing guidance
- Supersedes FASB 52, 80, as well as TB 2003-1
- Governments generally report derivatives at fair value

GASB 53 – A and FR for Derivatives (cont.)

- Exclusions:
 - Normal purchases and sales contracts
 - Insurance contracts accounted for under GASB Statement No. 10
 - Certain financial guarantee contracts
 - Certain contracts that are not exchange-traded
 - Loan commitments

GASB 53 – A and FR for Derivatives (cont.)

- Definitions
 - Definitions from TB 2003-1 and FASB 133 continued
 - Settlement factors (reference rates, notional amounts, etc.)
 - Leverage
 - Net settlement

GASB 53 – A and FR for Derivatives (cont.)

- Measurement
 - Fair value used – enterprise funds & government-wide statements
 - Hedging derivatives
 - Statement of net assets
 - Deferred inflows of resources or deferred outflows of resources

GASB 53 – A and FR for Derivatives (cont.)

- Hedging and hedge accounting
 - Requirements
 - Management's objective is to establish a hedge
 - Hedging instrument is a derivative
 - Hedging derivative associated with hedgeable item
 - Hedge not effective – fair value accounting – generally gains and losses accounted for in investment income
 - All hedges evaluated annually for effectiveness
 - Evaluation may be for current year or for inception to date
 - Basis swaps are never hedges (if that is all that is being changed)
 - For effective hedges – recognize fair value changes as deferred inflows and deferred outflows of resources

GASB 53 – A and FR for Derivatives (cont.)

- Methods for evaluating hedge effectiveness
 - Consistent critical method
 - Quantitative techniques
 - Synthetic instrument
 - Dollar-offset
 - Regression
 - Other quantitative methods
- Voluminous note disclosures required

GASB Statement 79

Certain External Investment Pools and Pool Participants

Background

- Previous standards allow pools that are considered to be 2a7-like to report investments at amortized cost rather than fair value
 - The SEC recently made significant changes to Rule 2a7
 - Concerns were raised regarding the cost-benefit of government pools applying the revised Rule 2a7 provisions
- This statement would not apply to the NCCMT Government Portfolio and the NCCMT Term Portfolio
 - The Term Portfolio is registered with the SEC and is a bond fund
 - The Government Portfolio is registered with the SEC - not currently affected by the GASB's proposed changes – would have to de-register to benefit from any changes

Summary of Provisions

- GASB separated accounting and financial reporting from SEC requirements
- Driven by amortized cost approximating fair value
- Patterned after 2010 SEC regulations for 2a7 funds
- Some of the 2010 regulations were excluded (e.g., stress testing) if they were operational in nature
- Significant instances of noncompliance would require a switch to fair value accounting
 - Professional judgment required
 - Significant means material
 - Switch back to amortized cost possible in future periods

Criteria Categories

- Pool should transact with participants at a stable net asset value (NAV) – if NAV floats, an external investment pool should use fair value
- Portfolio maturity limits
- Portfolio quality requirements
- Portfolio diversification requirements
- Portfolio liquidity limits
- Shadow pricing requirements