Accounting and Financial Reporting for Cash and Investments

Cash Management and Investment of Public Funds

Presented by

Lee Carter

NCCMT

GASB Statement No. 31 Key Provisions

- Investments reported at fair value
  - Quoted market prices
  - Amount exchanged between willing parties
- Applicable to….
  - Participating interest-earning investment contracts
  - External investment pools
  - Open-end mutual funds
  - Debt and equity securities

Exceptions to Fair Value Accounting and Reporting

- External investment pools
  - Debt securities with *remaining* maturity of 90 days or less from the balance sheet date – cost / amortized cost
  - SEC-registered 2a-7 funds (NCCMT) – cost / amortized cost
  - 2a-7 like funds – cost / amortized cost
  - Pools with legally binding guarantees for share prices (STIF) - cost

Exceptions to Fair Value Accounting and Reporting (cont.)

- Entities other than pools
  - Money market instruments with *original* maturity of one year or less – cost / amortized cost
    - Commercial paper
    - Banker's acceptances
    - T-bills
    - Does not include asset-backed securities, derivatives and structured notes
  - Non-participating interest-earning investment contracts - cost

GASB Statement No. 31
Specific Reporting Requirements

- 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

- Methods/assumptions used to estimate fair value
- Amortized cost option
- Definitions of realized vs. unrealized gains/ losses
- Income from one fund assigned to another
- Various external pool disclosures

GASB Statement No. 3

- Resulted from investment losses incurred in the 1980's
- Reflective of an environment where more securities were actually certificated
- Primarily addresses custodial risk - does not deal as specifically with market risk and credit risk

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
- 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 Cash – AAAm; 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 1 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, not a problem

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 Cash 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
- Accounting basis of deposits and investments
  - Cost/amortized cost
  - Fair value
- Statutory noncompliance
- Cash and cash equivalents

Other Deposit/Investment Presentations and Disclosures

- Discretely presented component unit considerations
  - Disclosures made when material to primary government
  - Must be distinguished from the primary govt.
- Reconciliation to balance sheet optional
- 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
  - Supporting paragraphs modified

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

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

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 items

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

GASB 53 - Main Note Disclosures

- Summary of derivative instrument activity
- Carry-forward of Technical Bulletin 2003-1 disclosures - supersedes Technical Bulletin 94-1, *Disclosures about Derivatives and Similar Debt and Investment Transactions*
- Disclosures may be aggregated for similar derivative types
- Information organized by governmental, business-type and fiduciary activities
- Information divided into 3 broad categories: fair value hedges, cash flow hedges, and investment derivative instruments

GASB 53 - Summary of Derivative Instrument Activity

- Notional amount
- Changes in FV during year and locations in the financial statements where those FV changes are reported
- FV at end of the reporting period and the locations in the financial statements where those FVs are reported
- If derivative instruments reported other than at quoted market prices, disclose methods and assumptions used to estimate FV
- FV of derivative instruments reclassified from a hedging derivative to an investment derivative instrument
- Disclosure of deferral amount that was reported in investment income

GASB 53 - Hedging Derivative Instruments

- Objectives for entering instruments
- Terms (notional amount, reference rates, embedded options, period, etc.)
- Risks
  - Credit (derivative instrument reported as asset) – credit ratings, netting, concentrations, collateral, etc.
  - Interest rate
  - Basis
  - Termination
  - Rollover
  - Market access
  - Foreign currency
- Hedged debt – net cash flows
- Other quantitative methods – discuss method used

GASB 59 – Financial Instruments Omnibus

- To use amortized cost – 2a7-like funds must follow ALL of the 2a7 requirements including having a separate board
- Interest rate risk disclosures are only made for bond funds and other debt pools that are not 2a7-like pools or 2a7 funds
- Unallocated insurance contracts – treat as interest-earning investment contracts (follow requirements for participating & non-participating)
- NCGA Statement 4 (guarantees of the indebtedness of others) amended to limit to debt instruments that are not derivatives entered into primarily for obtaining income or profit – GASB Statement 70 makes no real changes to this provision

GASB 59 – Financial Instruments Omnibus (cont.)

- GASB 53 changes
  - Contracts that have non-performance penalties are not considered to be the same as net settlement
  - Revenue-based contracts that are not exchange-traded are excluded from GASB 53
  - Excludes certain financial guarantee contracts from GASB 53 under certain circumstances (bond insurance, government guarantees debt of a development corporation, etc.)
  - Several other minor provisions

GASB 28 – Securities Lending

- This class omits discussion of accounting requirements for securities lending and reverse repurchase agreements
  - Securities lending requirements in GASB 28
  - Reverse repurchase agreements in GASB 3
  - Neither authorized for local governments under G.S. 159-30

GASB 64 – Application of Hedge Acctg. Termination Provisions

- Why was this statement issued?
  - Swap counterparty or swap counterparty credit support provider experiences default or termination event
  - Government replaces swap counterparty or counterparty's credit support provider by entering new swap or amending exiting agreements
  - Swap accounted for as a hedging derivative
  - Is government required to terminate hedge accounting treatment under these conditions?

GASB 64 – Application of Hedge Acctg. Termination Provisions

- No, hedging relationship continues when swap counterparty or swap counterparty credit support provider replaced with an assignment or in-substance assignment
- Assignment – swap counterparty or counterparty credit support provider replaced, but no other changes
- In-substance assignment – party is replaced, but the new agreement is essentially the same as the old agreement and any payment was established under the old agreement
- Implementation date – fiscal years beginning after 6/15/11

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

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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

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Valuation Techniques

- Apply valuation technique(s) that best represents fair value 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

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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, or other than quoted prices that are observable
- **Level 3**: unobservable inputs, least reliable

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Measurement—Net Asset Value Per Share (NAV)

- Measuring fair value of investments in certain entities that calculate net asset value (NAV) per share or its equivalent
- NAV per share may be used as a practical expedient to estimate fair value
  - Adjustment to NAV per share amount may be necessary to be consistent with measurement principles
  - May be applied on an investment-by-investment basis but must be applied consistently to fair value measurement of the government's entire position in a particular investment
- If sale of a portion of an investment at an amount different from net asset value per share is probable, the practical expedient may not be applied

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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

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Fair Value Application

- Assets that meet the definition of an investment generally should be measured at fair value
  - 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
  - Invested securities lending collateral
  - Intangible assets
  - Land and land rights
  - Real estate
  - Lending assets
  - Natural resource assets

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
- Investments in 2a7-like pools
- 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

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Application of Acquisition Value

- Acquisition value (an entry price) replaces fair value for the following:
  - Donated capital assets
  - Donated works of art, historical treasures, and similar assets
  - Capital assets acquired through a nonexchange transaction
  - Capital assets received through a service concession arrangement

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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)

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Level 3 and NAV

- For fair value measurements categorized within Level 3 of the fair value hierarchy
  - The effect of those investments on investment income for the reporting period
- 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)

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GASB Exposure Draft

Accounting and Financial Reporting
for Certain External Investment Pools

External Investment Pools

- **What:** The GASB is considering revisions to the accounting and financial reporting standards for 2a7-like investment pools
- **Why:** Securities and Exchange Commission changes to Rule 2a7 would make it difficult for external investment pools to meet the criteria to report as 2a7-like
- **When:** Exposure Draft issued - June 2015

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Background

- Current 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
- The project is considering criteria independent of Rule 2a7 that could be applied by external investment pools to determine when a cost-basis can be applied to investments.
  - The current 2a7 provisions and other regulatory provisions are being used as starting point.
- This project would not apply to the NCCMT Cash (Government) Portfolio and the NCCMT Term Portfolio
  - The Term Portfolio is registered with the SEC and is a bond fund
  - The Cash 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

Proposal Summary

- GASB separated accounting and financial reporting from SEC requirements
- ED 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

Tentative 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

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Proposed Implementation

- FY ending after 6/15/15 – except for shadow pricing and credit quality requirements which would be implemented for FY ending after 12/15/15
- External pools choosing to report at fair value after implementation would never be allowed to revert back to amortized cost
- External pools not qualifying for amortized cost in some years might be allowed to use amortized cost in future years under certain circumstances
- External pools using amortized cost would be allowed to switch to fair value in future years

Project Timeline

Pre-Agenda Research Starts	August 2014
Added to Current Technical Agenda	December 2014
Exposure Draft	June 2015
Final Statement Expected	December 2015