STATE OF NORTH CAROLINA
Office of the State Controller

Financial Reporting Update

GASB 72 Effective for FY 2016

February 10, 2016

Update: May 4, 2016 – Added link to GASB Implementation Guide No. 2016 – 1, added information on donated assets, revised and added information on investments that are valued at NAV per share; revised and added information to the GASB 72 Implementation section; added appendices A and B.

Update: April 2, 2018 – Removed the example stating a university's position in the UNC Investment Fund should be leveled in the fair value hierarchy; revised and added information regarding disclosures of a participant's position in an external investment pool; added link to GASB Implementation Guide No. 2017 – 1. (Revisions and additions are highlighted in yellow).

In February 2015, the Governmental Accounting Standards Board (GASB) issued GASB Statement No. 72, *Fair Value Measurement and Application* (GASB 72). This Statement supersedes or amends parts of 14 existing statements. GASB 72 addresses accounting and financial reporting issues related to fair value measurements.

GASB 72 is effective for the fiscal year ending June 30, 2016. The objective of this Statement is to improve financial reporting by clarifying the definition of fair value for financial reporting purposes, establishing general principles for measuring fair value, providing additional fair value application guidance (i.e., what assets and liabilities should be measured at fair value), and enhancing disclosures about fair value measurements. This Statement will increase consistency, improve comparability, and provide more understandable and useful information for financial statement users.

The scope is limited to assets and liabilities that are currently measured at fair value (FV) (including derivative instruments) and certain investments not currently measured at FV. For example, a capital asset currently reported at cost that meets the new definition of an investment should be measured at FV. This Statement generally requires investments to be measured at FV, with certain exceptions. (Note – these exceptions are the same exceptions that exist under current authoritative standards). The measurement of liabilities at fair value remains limited to liabilities arising in connection with derivatives.

This Statement defines FV 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 – from the perspective of a market participant that holds the asset or owes the liability (a seller's perspective, not a buyer's). It is a market-based measurement, not an entity or government-specific measurement.

GASB 72 identifies three acceptable valuation approaches to determine fair value: the market approach, cost approach, and income approach.

- **Market approach** – uses prices and other relevant information generated by market transactions involving identical or similar items. Examples include quoted market prices, the market multiples technique, and the matrix pricing technique.
- **Cost approach** – measures FV based on the current cost to replace the present service capacity of an asset, taking into account functional (technological) or economic obsolescence, as well as

physical deterioration. This approach is rarely used.

- **Income approach** – discounts future amounts, such as cash flows or income and expenses, into a single current amount. Types of income approach techniques include the present value technique, option pricing model technique, and multiperiod excess earnings technique.

Valuation techniques should be applied consistently from period to period. Governments should use valuation techniques that are appropriate under the circumstances and for which sufficient data are available, maximizing observable inputs and minimizing unobservable inputs.

This Statement establishes a fair value hierarchy that classifies inputs to valuation techniques into three levels. Level 1 inputs are quoted prices (unadjusted) for *identical* assets or liabilities in active markets that a government can access at the measurement date. Level 2 inputs are inputs that are observable for an asset or liability, either directly (quoted market prices for *similar* assets or liabilities) or indirectly (correlated or corroborated from observable market information). Level 3 inputs are unobservable inputs for an asset or liability. The highest priority is given to Level 1 inputs and the lowest priority to Level 3 inputs. If FV is measured using inputs from more than one level, the measurement is considered to be based on the lowest priority level input that is significant to the entire measurement. For example, if a measurement has three significant inputs, two are Level 2 and one is Level 3, the FV measurement is categorized as Level 3 of the FV hierarchy.

Using quoted prices provided by third parties, such as pricing services or brokers, is permitted if a government has determined that quoted prices provided by those parties are developed in accordance with the provisions of GASB 72.

GASB 72 allows a government to use net asset value (NAV) per share (or its equivalent) for an investment in a nongovernmental entity that does not have a readily determined fair value, provided that the NAV is calculated consistent with the Financial Accounting Standards Board's (FASB) measurement principles for investment companies. The government should determine that the NAV per share (or its equivalent) is determined in that manner. The NAV per share (or its equivalent) is commonly used for certain alternative investments, such as private equity funds and hedge funds.

GASB 72 defines an investment 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. An asset is not considered an investment if it is part of a government's mission/programs. Student loans, for example, would not qualify as investments because they are not primarily profit-motivated and because they provide programmatic benefits. This Statement does change how fair value is measured, but it does not change the investments that must be measured at fair value. The determination of whether an asset is an investment is based on actions by a government's management at acquisition. This classification should be retained for financial reporting purposes, even if the government's usage of the asset changes over time. For example, an asset that is initially reported as a capital asset and later is held for sale should not be reclassified as an investment.

Certain capital assets should no longer be reported at fair value. Donated capital assets, donated works of art and historical treasures, and capital assets received in service concession arrangements should be measured at acquisition value. This is the price that would be paid to acquire an asset with equivalent service potential in an orderly market transaction at the acquisition date (entry price). This requirement should be applied prospectively to transactions beginning in fiscal year 2016. Refer to questions 4.54, 4.55, and 4.59 in the GASB Implementation Guide No. 2016-1 for guidance on determining acquisition value.

GASB 72 requires additional disclosures. These disclosures are incremental to the existing disclosure requirements (i.e., GASB Statement 40 disclosures are still required). Disclosures should be organized by type of asset or liability. Several factors should be taken into consideration when determining the level of detail and disaggregation and how much emphasis to place on each disclosure requirement. Governments should disclose the following for recurring and nonrecurring fair value measurements:

1. FV measurement at the end of the reporting period,
2. Level of FV hierarchy within which the FV measurements are categorized in their entirety (level 1, 2, or 3),
3. Description of valuation techniques used in FV measurement, and
4. If there has been a change in valuation technique that has a significant impact on the result, that change and the reason for making it.

Additionally, for nonrecurring FV measurements, (i.e., impaired capital assets no longer used by a government), the reason for the measurement should be disclosed.

Additional disclosures are required for investments in entities that meet all of the following criteria: a) calculate the NAV per share (or its equivalent), b) do not have a readily determinable FV, and c) are measured at FV on a recurring or nonrecurring basis during the period. Disclosures should help users understand the nature and risks of these investments and whether these investments are probable of being sold at amounts different from the NAV per share (or its equivalent). Disclosures for these investments should explain the investees' significant investment strategies and any factors that could affect the investments' liquidity.

Investments that are valued at NAV per share and meet the requirements of GASB 72 paragraphs 71-74 are not subject to the fair value hierarchy and the associated disclosures by level. Generally, these types of investments will meet the criteria in GASB 72 paragraphs 71-74. Investments valued at NAV per share that do not meet the requirements of GASB 72 paragraphs 71-74 are subject to the fair value hierarchy and the associated disclosures by level. Note: this does not apply to a participant's position in an external investment pool. For additional guidance, see Investments as a position in an external investment pool in the GASB 72 Implementation section below.

To gain additional understanding of GASB 72, please refer to the following resources:

a) The GASB webpage from which you may access a PDF file of GASB 72 as well as other GASB pronouncements – GASB Pronouncements
b) GASB News Release – GASB Issues Final Statement on Fair Value Measurement and Application
c) GASB In Focus - GASB Statement No. 72, Fair Value Measurement and Application
d) GASB Outlook - Spotlight on Fair Value: Application of the Definition of an Investment
e) GASB Outlook - What You Need to Know: Fair Value Measurement and Application
f) GASB Implementation Guide No. 2016-1
g) GASB Implementation Guide No. 2017-1

GASB 72 Implementation

Fair value hierarchy:

Entities should contact their investment custodians immediately to determine if they will be able to provide the information needed to make the level of fair value hierarchy disclosures (i.e., whether investments are valued with level 1, 2, or 3 inputs). Entities should review any information provided by their custodian for reasonableness and compliance with GASB 72 requirements. Many of these reports/statements are prepared using FASB guidance. FASB recently issued an amendment to its FV standard removing the requirement to categorize all investments within the FV hierarchy for which FV is measured using the NAV per share practical expedient. FASB previously required leveling for investments measured using the NAV per share. Some custodian and/or fund manager reports may not reflect this FASB change. Each entity will need to understand the methodology used to categorize investments to ensure the leveling categories are in compliance with GASB 72. GASB 72 does not require leveling for investments using the NAV per share if the criteria in paragraphs 71-74 are met. If this information cannot be obtained from the investment custodian, then entities will be responsible for determining this information.

Applying the FV definition to liabilities:
The FV measurement of a liability assumes it is transferred to a market participant (but not extinguished) at the measurement date (i.e., assumes an ongoing obligation; not settlement of an obligation). The liability would remain outstanding and the market participant transferee would be required to fulfill the obligation. For derivatives, such as interest rate swaps, the FV is not the settlement value provided by the counterparty. Fair value must be measured in accordance with GASB 72 and consider the "non-performance risk" of the government. This includes a government's own credit risk, as well as, the credit risk of the counterparty. The price received to transfer a liability to a market participant is a better measure of FV than the amount needed to settle with the counterparty.

Using NAV when FV is not readily determinable:
The NAV can be used as a practical expedient for the FV of investments if the NAV is calculated as of the government's measurement date and is calculated in a manner consistent with FASB's measurement principles for investment companies. If the NAV is not calculated as of the government's fiscal year-end, then an adjustment to the NAV is required to report FV as of year-end. Refer to the GASB Implementation Guide No. 2016-1, question 4.44. The government should determine if the NAV is calculated consistent with the measurement principles for investment companies. If it is not, then the NAV provided by the investment company cannot be used and it is the entity's responsibility to determine the FV at year-end.

Applying the new investment definition:
Entities should evaluate their assets and determine if they meet the GASB 72 definition of an investment. The classification should be based on facts and circumstances in fiscal year 2016 rather than those in existence at the time the asset was initially acquired. When applying the definition of investments, the mission of the entity should be considered. If assets meet the definition of an investment, then they should be reported at fair value, unless specifically exempt. This could result in restatements. For example, if a building was previously reported as a capital asset but meets the definition of an investment then the building should be reported as an investment at fair value and a restatement reported, if material. Likewise, if land was previously classified as an investment but based on GASB 72, it no longer meets the definition of an investment, it should be reported as a capital asset and a restatement reported, if material. Once the classification of the asset is determined in FY 2016, the classification should not be changed. Refer to the GASB Implementation Guide No. 2016-1, question 4.53. Also refer to questions 4.33, 4.36, 4.37, 4.38, and 4.39 for examples of assets classified as investments and capital assets.

Note disclosures:
For entities that present comparative financial statements, note disclosures for the prior fiscal year should be presented in accordance with GASB 72.

Investments as a position in an external investment pool:
The level of fair value hierarchy is not required to be disclosed for a participant's position in an external investment pool. See GASB Implementation Guide No. 2017-1, question 4.36. For example, a university's position in the UNC Investment Fund is exempt from leveling disclosures. The other disclosures in GASB 72 paragraph 81 apply to the participant's position in the external investment pool. The disclosures in GASB 72 paragraph 82 do not apply. This also applies in stand-alone financial statements of universities, colleges, and other entities, when reporting their position in the Department of State Treasurer external investment pool (short-term investment fund, STIF, or bond index fund, BIF).

For additional information regarding the GASB 72 implementation, please refer to the following resources:

- Appendix A: Fair Value Hierarchy–Common Examples – See Attachment below.
- Appendix B: Valuation Techniques-Common Examples – See Attachment below.

Thank you for your time and attention to this important change. Questions regarding this specific update should be directed to Joy Darden at (919) 707-0520 or joy.darden@osc.nc.gov.

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GASB 72 Appendix A
Fair Value Hierarchy - Common Examples

NOTE: These are common examples and should be used as a guide. Entities should contact their investment custodian, fund manager, etc. to determine the appropriate fair value hierarchy level for each asset/liability.

Level 1
- Equity securities actively traded in exchange or dealer markets
- Common stock that is actively traded
- Exchange Traded Funds
- Preferred Stock
- Listed American Depositary Receipts (ADR's)
- Listed futures and options contracts
- "On-the-run" U.S. Government and Agency bonds (See note 1)
- Options on Securities - exchange traded

Level 2
- Corporate bond issuances not traded in an active market
- Certain asset-backed securities
- Certain mortgage-backed securities
- Municipal bonds not traded in an active market
- Collateralized Mortgage Obligations (CMOs)
- "Off-the-run" U.S. Government and Agency bonds (See note 1)
- Interest rate swaps
- Unlisted American Depositary Receipts (ADR's)
- Unlisted Preferred Stock
- Foreign Government Bonds
- Options on Indices
- Options on Securities - Non-exchange traded

Level 3 (See Note 2)
- Subordinate (residual) tranches in securitization structures
- Private equity investments
- Most nonfinancial assets

Note 1:
"On the run" U.S. government and agency bonds are the most recently issued bonds/notes of a particular maturity. "Off-the-run" refers to securities that have been issued before the most recent issue and are still outstanding.

Note 2:
Most alternative investments, such as private equity funds and hedge funds, do not have a readily determinable fair value. GASB 72 permits a government to establish the FV of these types of investments in nongovernmental entities by using the NAV per share (or its equivalent). If the requirements in GASB 72, paragraphs 71 - 74, are met, leveling disclosures are not required for these FV measurements.

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GASB 72 Appendix B
Valuation Techniques - Common Examples

NOTE: These are common examples and should be used as a guide. Entities should contact their investment custodian, fund manager, etc. to determine the appropriate valuation technique that was used to measure fair value.

Market Approach	
Technique	**Examples of Common Usage**
Quoted prices in an exchange market	Equity securities, futures
Quoted prices in dealer markets	On-the-run Treasury notes (See Note 1)
Market multiples technique relies on the use of multiples or ratios as an expression of market price relative to a key statistic, such as earnings, book value, or cash flows. It uses multiples or ratios derived from a set of comparable assets (e.g., a price to earnings ratio expresses an entity's per-share value in terms of its earnings per share).	Unlisted equity interests
Matrix pricing - relies on the securities' relationship to benchmark quoted prices.	Debt securities similar to benchmark quoted securities, such as corporate bonds, U.S. agencies, U.S. Treasuries, and municipal obligations. Preferred Stock

Income Approach	
Technique	**Examples of Common Usage**
Present value technique - FV measurement reflects current market expectations about those future amounts.	Debt securities with little, if any, trading activity, such as asset-backed securities and corporate bonds. Unlisted equity instruments

Cost Approach	
Technique	**Examples of Common Usage**
Depreciated replacement cost (DCR) method: considers how much it would cost to replace an asset of equivalent utility taking into account physical, functional and economic obsolescence; it estimates the replacement cost of the required capacity rather than the actual asset.	Capital assets classified as investments.

Note 1:
"On the run" U.S. government and agency bonds are the most recently issued bonds/notes of a particular maturity. "Off-the-run" refers to securities that have been issued before the most recent issue and are still outstanding.