Session Four:

Investment Accounting and Disclosures

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Patricia Song – City of Corona

CDIAC/CMTA January 19, 2017
INVESTMENT ACCOUNTING
Terminology/Definitions

• GASB – Government Accounting Standards Board
  • The source of generally accepted accounting principles (GAAP) used by state and local governments in the United States
• GASB 72 – Fair Value Measurement and Application (FY 2016)
Definition of Investment (GASB 72)

• A security or other asset that:
  • A government holds primarily for the purpose of income or profit, and
  • Has present service capacity based solely on its ability to generate cash or to be sold to generate cash
    • Now will include real property held for development
    • Implementation guide gives guidance to look at the investment intent at the time of implementation, do not look back.
Definition of Cost Basis/Purchase Price

• Cost basis is the original value of an asset, usually the purchase price.

• This value is used to determine the capital gain, which is equal to the difference between the asset's cost basis and the current market value.

• The term can also be used to describe the difference between the cash price and the futures price of a given commodity.
Definition of Fair Value

• Price to be received to sell an asset or paid to transfer a liability ("Exit Price")

• Not to be adjusted for additional costs relating to the transaction

• Market-based measurement, not entity-specific measurement
Fair Value Measurement - Assets

- Value should be at the asset’s highest and best use and assumes transaction takes place in the government’s principal or most advantageous market

  - Government’s current use is presumed to be highest and best use

  - Could be in combination with other assets and liabilities or on a stand-alone basis
• Example of liability would be derivative liability (interest rate swap most common for government’s)

• Fair value would take government’s credit standing into account

• If no active market

  • Consider liabilities held by other parties as assets and value of those assets

  • If above not available, use most relevant valuation technique (Discussed later)
GASB 31

ACCOUNTING AND FINANCIAL REPORTING FOR CERTAIN INVESTMENTS AND FOR EXTERNAL INVESTMENT POOLS
GASB 31 set Accounting and Financial Report Standards

- Valuation of investments
  - Fair Market Value (FMV)

- Exceptions
  - External investment pools investments may report at amortized cost money market investments that have a remaining maturity at the time of purchase of one year or less. (short-term, highly liquid debt instruments)
  
  - External investment pools – NOT 2a7-like pools, report at the fair value per share of the pool’s underlying portfolio

  - 2a7-like pools report by the pool’s share price
Recognition and Reporting

- Investment Income – includes changes in the fair market value of investments
- Earnings and changes in FMV stay in the fund in which the investment is reported, unless legal or contractual reasons (not management decision)
- If management decision and no legal restriction, then should be reported as an operating transfer

GASB 31 set Accounting and Financial Report Standards
**FMV CHANGE EXAMPLE**

GASB 31 Allocation - LAIF

Market Value rate at 6/30/2016: 1.000621222

### Cash and Investment - Pooled

<table>
<thead>
<tr>
<th>Fund</th>
<th>Fund Name</th>
<th>Cash Balance 6/30/2016</th>
<th>Unrealized</th>
<th>FMV 6/30/2016</th>
<th>FMV PY 6/30/2015</th>
<th>Change in FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>100</td>
<td>General Fund</td>
<td>1,100,000</td>
<td>683.34</td>
<td>1,100,683.34</td>
<td>1,009,543.34</td>
<td>91,140.00</td>
</tr>
<tr>
<td>120</td>
<td>Gas Tax</td>
<td>210,000</td>
<td>130.46</td>
<td>210,130.46</td>
<td>199,025.34</td>
<td>11,105.12</td>
</tr>
<tr>
<td>130</td>
<td>Housing</td>
<td>100,000</td>
<td>62.12</td>
<td>100,062.12</td>
<td>125,001.45</td>
<td>(24,939.33)</td>
</tr>
<tr>
<td>140</td>
<td>Prop A</td>
<td>78,000</td>
<td>48.46</td>
<td>78,048.46</td>
<td>85,435.45</td>
<td>(7,386.99)</td>
</tr>
<tr>
<td>200</td>
<td>Capital Projects</td>
<td>75,000</td>
<td>46.59</td>
<td>75,046.59</td>
<td>72,451.25</td>
<td>2,595.34</td>
</tr>
<tr>
<td>300</td>
<td>Debt Service</td>
<td>200</td>
<td>0.12</td>
<td>200.12</td>
<td>200.45</td>
<td>(0.33)</td>
</tr>
</tbody>
</table>

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<tr>
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<td>0.12</td>
<td>200.12</td>
<td>200.45</td>
<td>(0.33)</td>
</tr>
</tbody>
</table>

**Increase in FMV**
- Debit - Cash
- Credit - Investment Income

**Decrease in FMV**
- Debit - Investment Income
- Credit - Cash

Total: $1,563,200.00 Increase in FMV - $971.09 Decrease in FMV

Total: $1,564,171.09 $1,491,657.28 $72,513.81
GASB 31 sets accounting and financial report standards

• Disclosures
  • Methods and significant assumptions used to estimate the FMV, if other than quoted market price
  • Policy for reporting at amortized costs, if any
  • Investments in external investment pools that are not SEC-registered, provide a brief description of any regulatory oversight (LAIF)
  • Any involuntary participation in external investment pools
  • Any income from investments associated with one fund that is assigned to another fund (legal or contractual provisions)
The City is a voluntary participant in the California Local Agency Investment Fund (LAIF) that is regulated by California Government Code Section 16429 under the oversight of the Treasurer of the State of California. LAIF is overseen by the Local Agency Investment Advisory Board, which consists of five members, in accordance with State statute. The State Treasurer’s Office audits the fund annually. The fair value of the position in the investment pool is the same as the value of the pool shares.
GASB 72

FAIR VALUE MEASUREMENT AND APPLICATION
Valuation Techniques

• Apply techniques that best represent fair value in the given circumstances

• The goal is to maximize observable inputs and minimize unobservable inputs when deciding which technique is best
Valuation Techniques (Continued)

- Techniques:
  - Market Approach
  - Cost Approach
  - Income Approach

- Techniques should always be applied consistently across periods; changes required in certain circumstances

- Revisions to fair value due to change in technique is considered a change in accounting estimate
  - Applied in current period and disclosed in footnotes
Valuation Technique – Market Approach

• Uses prices and other relevant information generated by market transactions involving identical or similar assets and/or liabilities

• Examples would be sale price of identical investment or price listed on stock market
Valuation Technique – Cost Approach

• The amount that would be required to currently replace the asset, or the service capacity of an asset

• Often used to measure fair value of tangible assets such as plant and equipment
Valuation Technique – Income Approach

• Converting expected future amounts (cash flows or earnings) into a single current discounted amount

• Consideration of future amounts can extend in many periods or few
  • Would include present value techniques, option-pricing models, etc.

The Income Approach reflects the value of a property's earning power based on the capitalization of its income.
Fair Value Hierarchy

• 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 that are not active, or other than quoted prices that are still observable

• Level 3 – Unobservable inputs
  • Least reliable (Management assumptions often involved)
• If fair value of asset/liability is measured using inputs from more than one level of the fair value hierarchy, measurement is considered based on lowest priority level input significant to the entire measurement.

• Example – If three inputs are significant to fair value measurement, two of them being level 2 and one being level 3, fair value measurement would be categorized as level 3.
• 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
Level 1 Inputs

• Exchange markets (NYSE)

• Brokered markets (Real estate market)

• Dealer market (Market for U.S. Treasury Securities)

• Principal-to-principal markets

• May be available for many financial assets and liabilities
Level 2 Inputs

- Quoted prices for similar assets/liabilities in active markets

- Quoted prices for similar assets or liability in inactive markets

- Observable inputs other than quoted prices:
  - Interest rates and yield curves
  - Implied volatilities
  - Credit spreads

- Market-corroborated inputs
Level 3 Inputs

- Should develop using best information available

- Developing unobservable inputs can begin with government’s own data, but should be adjusted if:
  - Information indicates other market participants would use different data
  - Something is particular to government that is not available to other market participants

- Should take into account all information about market participation assumptions reasonably available
Acquisition Value

• This statement requires measurement at acquisition value for the following:

  • Donated capital assets
  • Donated works of art, historical treasures, and similar assets
  • Capital assets received through a service concession arrangement
Footnote Disclosures

• Should be organized by type or class of asset or liability based on:
  • Nature, characteristics, and risks of the asset or liability
  • Level of fair value hierarchy within which fair value measurement is categorized (Level 1, 2, 3)
  • Relevant significance of assets and liabilities measured at fair value compared to total assets and liabilities
  • Whether separately issued financial statements are available

• Can be shown in table or narrative format
“The City categorizes its fair value measurements within the fair value hierarchy established by generally accepted accounting principles. The hierarchy is based on the valuation inputs used to measure the fair value of the asset. Level 1 inputs are quoted prices in active markets for identical assets; Level 2 inputs are significant other observable inputs; Level 3 inputs are significant unobservable inputs.”
“The City has the following recurring fair value measurements as of June 30, 20XX:”

<table>
<thead>
<tr>
<th>Investment Type</th>
<th>6/30/2016</th>
<th>Level 1</th>
<th>Level 2</th>
<th>Level 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Treasury Securities</td>
<td>$1,000,000</td>
<td>$</td>
<td>$1,000,000</td>
<td>$</td>
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<tr>
<td>Mutual Funds</td>
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<td>10,000,000</td>
<td>-</td>
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<tr>
<td>Corporate Bonds</td>
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<td>12,000,000</td>
<td>-</td>
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<tr>
<td>LAIF</td>
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<tr>
<td>Mortgage-backed securities</td>
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<td>-</td>
<td>25,000,000</td>
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<tr>
<td><strong>TOTALS</strong></td>
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<td>$</td>
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<td>$25,000,000</td>
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## Disclosure Support

**“FAIR VALUE LEVELING REPORT”**

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**GASB 72 Level Pricing Report**

As of 06/30/2016  
Dated: 11/17/2016

<table>
<thead>
<tr>
<th>Security Type Category</th>
<th>Level 1</th>
<th>Level 2</th>
<th>Level 3</th>
<th>Other</th>
<th>Total</th>
</tr>
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<tbody>
<tr>
<td>Agency</td>
<td>0.00</td>
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<td>0.00</td>
<td>27,937,150.00</td>
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<tr>
<td>Agency MBS</td>
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<td>0.00</td>
<td>239,488.62</td>
</tr>
<tr>
<td>Asset Backed</td>
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<td>0.00</td>
<td>2,001,060.00</td>
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<tr>
<td>CD</td>
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<td>Corporate</td>
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<td>0.00</td>
<td>15,886,367.50</td>
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<tr>
<td>MM Fund</td>
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<td>26,134,815.79</td>
</tr>
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<td>US Cov</td>
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<td>33,942,929.55</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>0.00</td>
<td>112,498,630.38</td>
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</table>

### Level 2

<table>
<thead>
<tr>
<th>Description</th>
<th>Identifier</th>
<th>Fair Value Level</th>
<th>Current Units</th>
<th>S&amp;P Rating</th>
<th>Book Yield Yield</th>
<th>Original Cost</th>
<th>Market Value + Accrued</th>
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<tbody>
<tr>
<td>CHAIT 138 A</td>
<td>161571GC2</td>
<td>Level 2</td>
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<td>2,003,437.50</td>
<td>2,001,067.00</td>
</tr>
<tr>
<td>ABG</td>
<td></td>
<td></td>
<td></td>
<td>Aaa</td>
<td>0.833</td>
<td></td>
<td>2,001,060.00</td>
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<tr>
<td></td>
<td>FEDERAL HOME LOAN BANKS ACCY BOND</td>
<td>Level 2</td>
<td>1,000,000.00</td>
<td>AA-a</td>
<td>0.632</td>
<td>0.544</td>
<td>996,430.00</td>
</tr>
<tr>
<td></td>
<td>FEDERAL NATIONAL MORTGAGE ASSOCIATION ACCY BOND</td>
<td>Level 2</td>
<td>1,500,000.00</td>
<td>AA-a</td>
<td>1.154</td>
<td>0.862</td>
<td>1,526,865.00</td>
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<tr>
<td></td>
<td>FEDERAL FARM CREDIT BANKS FUNDING CORP ACCY BOND</td>
<td>Level 2</td>
<td>1,000,000.00</td>
<td>AA-a</td>
<td>1.155</td>
<td>1.057</td>
<td>993,960.00</td>
</tr>
<tr>
<td></td>
<td>FEDERAL HOME LOAN BANKS ACCY BOND</td>
<td>Level 2</td>
<td>1,500,000.00</td>
<td>AA-a</td>
<td>1.00</td>
<td>0.684</td>
<td>1,500,000.00</td>
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<tr>
<td></td>
<td>FEDERAL FARM CREDIT BANKS FUNDING CORP ACCY BOND</td>
<td>Level 2</td>
<td>1,000,000.00</td>
<td>AA-a</td>
<td>0.898</td>
<td>0.603</td>
<td>999,300.00</td>
</tr>
<tr>
<td></td>
<td>FEDERAL NATIONAL MORTGAGE ASSOCIATION ACCY BOND</td>
<td>Level 2</td>
<td>1,000,000.00</td>
<td>AA-a</td>
<td>1.743</td>
<td>0.921</td>
<td>994,940.00</td>
</tr>
</tbody>
</table>

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Exceptions

• New standard expands use of fair value, some of existing exceptions continue to be excluded

• Money Market Investments
• 2a7 External Investment Pools
• Investments in Life Insurance Contracts
• Unallocated Insurance Contracts
• Synthetic Guaranteed Investment Contracts
Understand GASB 72

• Goal
  • Improve Financial Reporting
  • Enhance Comparability

• Applicability
  • Does not apply to assets other than investments
  • Limited to liabilities that are currently measured at fair value
Impact to the City

• Re-evaluate on what should be considered as investment
  • Capital assets
  • Inventory
  • Investment

• Unit of Account
  • Primary purpose of asset (lease of City Hall)

• Additional Disclosure – Fair Value Level
Responsibility of the City

• Use of Investment Advisory Firm and/or Investment Custodian

• Ways to Review and Determine the proper classification
  • Discussion with consultants
  • Look up securities online
  • Check with fund managers
Challenges with Implementation

• Limited Challenges on Identifying Items Subject to Fair Value Reporting
  • Strict CA Government Code, very limited nontraditional investment (Private Equity, Hedge Funds etc.)
  • Original Intent and Unit of Account provisions in GASB 72 allows for exemption on certain unique situations (Lease of City Hall, rental of sports fields etc.)

• Challenges on Classifying Fair Value Levels
  • Level 1 vs. Level 2
  • Level 3 vs. Net Asset Value (NAV)
Section f. Fair Value Measurement and Application

The City categorizes its fair value measurements within the fair value hierarchy established by generally accepted accounting principles. The hierarchy is based on the valuation inputs used to measure the fair value of the asset. Level 1 inputs are quoted prices in active markets for identical assets; Level 2 inputs are significant other observable inputs; Level 3 inputs are significant unobservable inputs.

The City has the following recurring fair value measurements as of June 30, 2016:

<table>
<thead>
<tr>
<th>Investments</th>
<th>June 30, 2016</th>
<th>Measured at Fair Value</th>
<th>Level 1</th>
<th>Level 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Treasury</td>
<td>$44,667,988</td>
<td>$</td>
<td>$</td>
<td>$44,667,988</td>
</tr>
<tr>
<td>Federal Government Agency</td>
<td>88,652,930</td>
<td>$</td>
<td>$</td>
<td>88,652,930</td>
</tr>
<tr>
<td>Medium-Term Corporate Notes</td>
<td>52,608,859</td>
<td>$</td>
<td>$</td>
<td>52,608,859</td>
</tr>
<tr>
<td>Asset-Backed Securities</td>
<td>15,865,538</td>
<td>$</td>
<td>$</td>
<td>15,865,538</td>
</tr>
<tr>
<td>Money Market Funds</td>
<td>53,021</td>
<td>53,021</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Local Agency Investment Fund</td>
<td>44,669,235</td>
<td>$</td>
<td></td>
<td>44,669,235</td>
</tr>
<tr>
<td>Total Cash Investments</td>
<td>246,517,571</td>
<td>53,021</td>
<td></td>
<td>246,464,550</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Restricted Investments:</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Local Agency Investment Fund</td>
<td>3,488,500</td>
<td></td>
<td></td>
<td>3,488,500</td>
</tr>
<tr>
<td>Federal Government Agency</td>
<td>998,330</td>
<td></td>
<td></td>
<td>998,330</td>
</tr>
<tr>
<td>Medium-Term Corporate Notes</td>
<td>38,853,704</td>
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<td>38,853,704</td>
</tr>
<tr>
<td>Total Restricted Investments</td>
<td>43,340,534</td>
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<td></td>
<td>43,340,534</td>
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<tr>
<td>Total Investments</td>
<td>$289,858,105</td>
<td>$53,021</td>
<td>$</td>
<td>$289,805,084</td>
</tr>
</tbody>
</table>

Total Investments

$289,858,105
Questions

Thank you