Government Finance Officers Association

Testimony before the

GOVERNMENTAL ACCOUNTING STANDARDS BOARD

Concerning its preliminary views on

FAIR VALUE MEASUREMENT AND APPLICATION

Flushing, New York
November 1, 2013

We are here today on behalf of the Government Finance Officers Association (GFOA) to offer testimony in response to the Governmental Accounting Standards Board’s (GASB) recent preliminary views (PV) on the Fair Value Measurement and Application. This testimony was jointly prepared by the GFOA’s standing Committees on 1) Accounting, Auditing, and Financial Reporting (CAAFR), 2) Retirement and Benefits Administration (CORBA), and 3) Treasury and Investment Management (TIM).

Overview

The GFOA generally supports the GASB’s proposals for fair value measurement and application in the context of reporting on an economic resources measurement focus/accrual basis of accounting. We don’t believe that the application of fair value is appropriate in the case of reporting on a current financial resources measurement focus/modified accrual basis of accounting. This difference in measurement focus/basis of accounting for governmental funds has been a consideration in the development of previously issued standards. For example, the recognition and measurement provisions of GASB Statement No. 53, Accounting and Financial Reporting for Derivative Instruments, do not apply to financial statements prepared using the current financial resources measurement focus. We also believe that an exception should be made in this case so that investments in governmental funds would not be reported at fair value.

We know that fair value currently applies to the investments of governmental funds. However, that requirement was set forth in GASB Statement No. 31, Accounting and Financial Reporting for Certain Investments and for External Investment Pools, which was issued at a time before the government-wide financial statements were available to provide this information. Accordingly, our proposal to exclude the investments of governmental funds from the requirement for fair value reporting would not result in any information loss. These investments would still be reported at fair value when included in governmental activities in the government-wide financial statements.

Specific Recommendations

We believe additional discussion should be provided in a number of situations to ensure that any subsequent proposals or guidance will not be misunderstood.
Application of the fair value definition. We generally agree with the proposed fair value definition and the changes that were made from the current definition in the context of reporting on an economic resources measurement focus/accrual basis of accounting. We agree in theory that the concept of fair value can apply to a liability. However, by including liability in the general discussion that chapter 2 provides about fair value measurements, we believe that it creates the expectation that the proposals will require the reporting of liabilities at fair value. We also believe that the title of chapter 3, Application of Fair Value to Assets and Liabilities, further reinforces the idea that liabilities, in general, are subject to the fair value provisions of the PV. We believe this is true even though that chapter does not talk about the application of fair value to any specific liability.

As we understand the PV, it is not proposing such a general requirement for liabilities. Instead, the discussion is only talking in general terms about fair value and that a requirement to report a liability at fair value would have to come from a future pronouncement. In fact, the only specific mention of reporting a liability at fair value is in the document’s summary which states:

Fair value also may apply to certain liabilities. An example is an interest rate swap that is in a liability position to a government. The fair value of such a liability would be the price to transfer it to a market participant at the measurement date. The liability would be assumed to remain outstanding, requiring the assuming market participant to fulfill the obligation. Additionally, the fair value measurement would take into account the effect of nonperformance risk, which includes a government’s own credit risk and any other factors that might influence the likelihood that the obligation would or would not be fulfilled.

Accordingly, we urge the GASB to clarify that the definition includes both asset and liability to make it comprehensive, but that there is not a current proposal for the fair value reporting of liabilities, in general. We do believe that the board intends for a liability that might arise in connection with a derivative instrument to be reported at fair value. Accordingly, if this is true, that fact should be clearly stated rather than leaving the discussion vague and entirely unclear about what, if any, liability the PV is requiring to be reported at fair value.

Transaction costs. We agree that fair value should exclude transaction costs. However, we believe the GASB should emphasize that this treatment applies even to situations where transaction costs are so significant that they could affect the decision whether to dispose of an investment (for example, real estate held as an investment). Otherwise, because of the downward effect that these period costs would have on net position when they are incurred we believe there could be a temptation to reduce fair value in a period earlier than when the costs are actually incurred.

Please note, that our agreement on the treatment of transaction costs is specific to investments. In other words, the guidance of excluding transaction costs should not be generally expanded to other assets. In the case of certain other assets, for example, the historical cost of capital assets, we believe that it is appropriate for transaction costs to be included in the historical cost of
capital assets provided that they meet the general rule that they are charges necessary to place the asset into its intended location and condition for use.

**Investment definition.** We agree with the proposed definition of an investment. However, we believe additional guidance should be provided to help distinguish between assets held as investments from assets held to provide service, especially in the case of real estate. A government, for example, may acquire land that will be used passively to provide services (land acquired to preserve the natural environment or to maintain open space). In that case, the property may generate cash from rights associated with the property (one such example, timber rights, was identified in the PV). In circumstances where the land is not held primarily for its ability to generate cash, to be sold to generate cash, or to procure services for the citizenry the PV states that it would not be an investment.

We are concerned, however, about situations where the cash generated becomes significant. We believe that some may want to classify the underlying asset as an investment even when the purpose has not changed. Further, we are concerned that in such a situation some may argue that the purpose for holding the asset has, in fact, changed to be primarily for the purpose of income or profit. In our view, the asset in this situation, would still not qualify as an investment. To avoid potential reclassification of assets to investments in inappropriate circumstances, we urge the GASB to enhance the definition of an investment or provide additional discussion on how to evaluate changes to the purpose for which an asset is held and when those changes should result in the treatment of the asset as an investment.

**Investment measurement.** We agree that investments generally should be measured at fair value and that the current exceptions to fair value reporting should be kept. In addition, there are other situations that should be exempt from fair value reporting. In the private-sector there is a held-to-maturity category of investments. Investments that meet the criteria for inclusion in this category are exempt from fair value reporting. We believe that a similar exception should be provided for governments. Another exception, in our view, should be “matched positions/matching maturities” (that is, situations where investment maturity dates are designed to provide resources when needed to liquidate specific liabilities).

We understand that such exceptions have not been added in the past at least partly because of the degree of subjectivity that would be involved in determining a government’s intent. We agree that there would be subjectivity in applying a held-to-maturity category of investments. However, we believe that the subjectivity in this case would be no greater than the subjectivity that has been accepted in recent standards issued by the GASB. In the case of “matched positions/matching maturities,” we believe there would be less subjectivity involved. Often in these cases there is a constraint, legal or otherwise, that will not allow the assets to be used for a purpose other than liquidating the specific liabilities.

We understand that the proposed hierarchy is similar to what is used in the private sector. However, we are not convinced that it is necessary to establish a hierarchy for the various inputs that a government may need to consider in determining the fair value of its investments. Instead, the GASB should explain the inputs to consider in determining fair value and emphasize the
need to disclose the specific inputs used. In any case, additional clarification is needed regarding the nature of “unobservable inputs” (level 3 inputs).

**Note disclosures.** We are concerned by the volume of the proposed disclosures. We are not convinced that it is necessary to provide information regarding the level of inputs used to determine fair value by investment type. Instead, the requirement to disclose “a description of the valuation techniques and the inputs used in the fair value measurement” provides all the truly essential information regarding fair value measurement.

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The GFOA appreciates being afforded the opportunity to testify at this hearing.