

June 3, 2013

DUE PROCESS DOCUMENTS SUPPLEMENT

Proposed Statement of Concepts  
and Preliminary Views of the  
Governmental Accounting  
Standards Board:  
Plain-Language Supplement

**Measurement Concepts for  
Assets and Liabilities and  
Fair Value Measurement and Application**

This plain-language supplement to an Exposure Draft of a Proposed Statement of Governmental Accounting Concepts and a Preliminary Views is issued by the Board for public comment.

Written comments should be addressed to:

Director of Research and Technical Activities  
Project Nos. 3-20E and 26-5P

User Webinar and Survey: September 5, 2013  
Comment Deadline: September 30, 2013



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**Proposed Statement of Concepts and Preliminary Views  
of the Governmental Accounting Standards Board:  
Plain-Language Supplement**

**Measurement Concepts for Assets and Liabilities and Fair Value  
Measurement and Application**

**June 3, 2013**

**CONTENTS**

	Page Number
Background and Overview .....	1
Accounting Standards and Accounting Concepts .....	1
The Purpose of This Document .....	2
Measurement Concepts .....	3
Measurement in the GASB's Conceptual Framework .....	3
Why Measurement Concepts Are Important .....	4
Measurement Approaches .....	4
Measurement Attributes .....	5
Alternative View .....	6
Summary of Proposals .....	7
Fair Value .....	7
Definition of Fair Value .....	8
Summary of Proposals .....	9
How Fair Value Would Be Measured .....	9
Investments in Certain Entities That Calculate Net Asset Value per Share .....	10
Summary of Proposals .....	11
How Fair Value Would Be Applied .....	11
Definition of an Investment .....	12
Exceptions to Fair Value .....	12
Use of Acquisition Value .....	13
Transaction Costs .....	13
Summary of Proposals .....	13
How Fair Value Would Be Disclosed .....	14
Level of Detail for Disclosures .....	14
Proposed Disclosures .....	15
Summary of Proposals .....	16
What Information Does the GASB Need to Proceed?.....	16
How Can You Share Your Opinions with the GASB?.....	17

**This document is a plain-language supplement to two due process documents issued by the Governmental Accounting Standards Board for public comment: an Exposure Draft, *Measurement of Elements of Financial Statements*, and a Preliminary Views, *Fair Value Measurement and Application*.**

**This supplement is prepared for citizens, taxpayers, elected representatives, municipal analysts, and other external users of governmental financial information. The supplement references the Exposure Draft and Preliminary Views and should be read in conjunction with them. They can be downloaded from the same location as this supplement—under the “Projects” tab at [www.gasb.org](http://www.gasb.org).**

**Questions for *users* of governmental financial information are posed throughout this supplement. Instructions for responding to the questions begin on page 17. The GASB is conducting a webinar and survey for users on September 5, 2013. (Details can be found at the end of this document.)**

***Preparers (including internal users of financial statements) and auditors of financial statements are requested not to answer the questions posed in this supplement.***

## **BACKGROUND AND OVERVIEW**

A primary goal of the Governmental Accounting Standards Board (GASB) is to develop high-quality standards of accounting and financial reporting for state and local governments. High-quality standards lead to information in financial reports that improves transparency, assists in assessing accountability, and is useful for making decisions.

### **Accounting Standards and Accounting Concepts**

In addition to governmental accounting *standards*, the GASB also issues governmental accounting *concepts*. Standards contained in the GASB’s pronouncements (such as Statements and Interpretations) represent guidance for the GASB’s constituents—the preparers, auditors, and users of financial statements—regarding how to account for and report a government’s finances. Accounting concepts, on the other hand, are intended primarily to guide the GASB itself as it establishes standards—to improve the consistency of the GASB’s requirements. For example, all things being equal, circumstances that lead to the reporting of an asset under one GASB pronouncement should result in the reporting of an asset under other pronouncements as well. GASB accounting standards usually require changes to how governments account for and report their finances, whereas GASB accounting concepts do not.

The framework of accounting concepts that the GASB has been developing since its inception in 1984 addresses five key issues that are the focus of the accounting standards that the GASB establishes:

- **Why should governments report information?** The “objectives of financial reporting” address at a high level the key questions that follow about financial reporting by governments and identify the reasons why legislators, taxpayers, bond analysts, and others need financial information about governments.
- **What information should governments report in financial statements?** Definitions of the “elements” of financial statements, such as assets and liabilities, help the GASB identify what should be reported as a result of transactions.
- **Where should governments present information in financial reports?** These concepts explain the circumstances under which information should be displayed on the face of financial statements, versus being disclosed in the notes to the financial statements or presented in supplementary schedules.
- **How should amounts be determined for the information governments report?** The concepts regarding “measurement” are the subject of the Exposure Draft that this plain-language supplement accompanies and are discussed further below.
- **When should governments report this information?** These concepts address the point at which a government should “recognize” the elements of financial statements that result from transactions and other events. The GASB proposed concepts on recognition in a 2011 Preliminary Views and expects to issue an Exposure Draft in 2014.

## **The Purpose of This Document**

This plain-language supplement accompanies two “due process documents” that the GASB has published for the purpose of obtaining public feedback:

- Exposure Draft, *Measurement of Elements of Financial Statements*
- Preliminary Views, *Fair Value Measurement and Application*.

The Exposure Draft proposes accounting *concepts* for the measurement of assets and liabilities. The Exposure Draft is essentially a final full draft of what is expected to become a Statement of Governmental Accounting Concepts. The Preliminary Views proposes new accounting *standards* regarding which assets and liabilities should be measured at their “fair value,” how that fair value should be determined, and what note disclosures should be provided with fair value measures. A Preliminary Views is used to collect public input prior to developing an Exposure Draft of a proposed Statement of Governmental Accounting Standards.

Plain-language supplements are intended for *users* of governmental financial information. They summarize and explain the proposals in the due process documents in a manner suitable to persons who are not accountants. In other words, they minimize the use of accounting jargon (or at least explain what the jargon means) and focus on the effects of the proposal on the information that users will receive as a result of the proposals. This document is divided into two main sections—one discussing the Exposure Draft of measurement concepts and the other discussing the Preliminary Views on fair value. Each section contains questions specifically written to ask users of governmental financial information how the GASB’s proposed changes would affect the decision-usefulness of

the information they receive from financial reports and their ability to assess government accountability.

## MEASUREMENT CONCEPTS

This section of the plain-language supplement addresses the proposed concepts in the Exposure Draft on measuring financial statement elements. The section begins by explaining what measurement concepts are, what they are intended to do, and why they are important. The section then proceeds to describe the Exposure Draft proposals regarding measurement approaches and measurement attributes—or, how assets and liabilities should be measured.

### Measurement in the GASB's Conceptual Framework

The accounting standards that the GASB sets lead to governments reporting information that meets at least one of the objectives of financial reporting. The concepts describing *what is reported* in financial statements (assets and liabilities, inflows and outflows of resources, deferred inflows and outflows of resources, and net position), *where it is reported* (financial statements, notes, or supporting information), and *when it is reported* (at the time of the transaction or at a point when something else occurs, such as another event or the passage of time) guide the GASB's development of the specific requirements in the standards.

Measurement concepts guide the GASB's decisions about *how to determine the dollar amount that will be reported* for the assets, liabilities, and other financial statement elements. Measurement concepts focus on determining the amounts of assets and liabilities. The amounts reported for other elements of financial statements are, in turn, based on the amounts that have been determined for the assets and liabilities. For example, when a public university receives a donation of stock in a corporation, it reports an asset and revenue. The asset and the revenue are not measured separately; rather, the value of the stock (the asset) is determined and that is the amount that would be reported for the revenue (the inflow of resources) as well. In subsequent years, gains and losses on the stock (also inflows and outflows of resources, respectively) would equal the increase or decrease in the value of the stock.

Setting accounting standards is constrained by concepts stating that the information governments are required to report should exhibit six *qualitative characteristics*:

- *Understandability*—The information can be understood by the user.
- *Reliability*—The information accurately depicts what it purports to depict and is verifiable and unbiased.
- *Relevance*—The information is capable of making a difference to the user when making decisions and assessing government accountability.
- *Timeliness*—The information is received by users in time to have an effect on their decisions and assessments.
- *Consistency*—The information is prepared the same way from year to year.

- *Comparability*—The information can be compared across governments.

The GASB considers the costs and benefits of potential accounting standards as it develops them. It is expected that the benefits of an accounting requirement (most notably, in terms of the value to users of the resulting information) will outweigh the costs of the requirement (principally, the cost to governments to comply).

## **Why Measurement Concepts Are Important**

Measurement concepts that will be used to determine the appropriate amounts for assets and liabilities provide a foundation to *depict a government's financial health* at a given point in time (its “financial position”) and *its financial activity* during a given period (its “results of operations” or “financial performance”).

Measurement concepts also help the GASB to establish standards that require essentially the same treatment of similar transactions. This promotes the ability to compare the financial information of one government with another. The amounts that each government determines will be different for a variety of reasons—the specifics of their assets and liabilities are different (for instance, the service capacity of a bridge, or the interest rate on general obligation debt), the assets are acquired and the liabilities are incurred at different times, and so on. Some differences also may result from alternatives allowed in the standards themselves, such as measuring inventory using first-in-first-out (FIFO) or last-in-first-out (LIFO). Measurement concepts should maximize the likelihood that accounting standards for measurement result in different governments coming up with comparable amounts for comparable assets or liabilities acquired or incurred under comparable circumstances.

Measurement concepts also help the GASB set standards that promote the other qualitative characteristics. Standards developed under those concepts should lead to the reporting of information that makes sense to the users (understandable), makes a difference to their decision making (timely), addresses their concerns (relevant), can be relied upon (reliability), and conveys meaning in the same manner from one year to the next (consistent).

## **Measurement Approaches**

**The GASB is proposing two approaches to measuring assets and liabilities—*initial amounts and remeasured amounts.***

Initial amounts (also known as *initial-transaction-date-based* amounts) are measured at the time an asset is acquired or a liability is incurred. (See paragraphs 10–12 of the Exposure Draft.) Initial amounts may be adjusted in subsequent years (for instance, through depreciation of a building or other capital asset), but the value of the asset or liability is not measured again. Even the writing down of a capital asset's value because of physical damage or another impairment is not a remeasurement, but an adjustment to the initial amount: The remaining service capacity of the asset after impairment is stated in terms of a portion of the original value reported for the asset, rather than a new value calculated at the time of the impairment.

On the other hand, remeasured amounts (also known as *current-financial-statement-date-based* amounts) are measured anew as of the date of each year's financial statements. (See paragraph 13 of the Exposure Draft.)

It is reasonable to ask why the GASB is proposing two measurement approaches rather than just one. The GASB believes that using two approaches would maximize the ability of accounting standards to meet the objectives of financial reporting. In particular, the measurement of asset and liability amounts is crucial to a user's ability to assess the following:

- The extent to which revenues are sufficient to cover the cost of providing services (known as *interperiod equity*)
- The types of financial resources a government takes in and what it uses them for
- How activities are financed and cash needs are met
- The level of services a government can provide and its ability to meet its obligations as they come due, based on its financial position and financial (economic) condition
- Capital assets (those with useful lives of more than a year) and other nonfinancial resources, and their potential for being used to provide services.

Initial amounts and remeasured amounts each have advantages over the other in terms of meeting these objectives and the qualitative characteristics. It is likely that some assets and liabilities would be more appropriately measured using initial amounts, whereas other assets and liabilities would be more appropriately measured using remeasured amounts. In general, the setting of accounting standards involves a balancing of the various accounting concepts and qualitative characteristics, which sometimes are in competition with one another.

In general, initial amounts are well suited to achieving the objectives related to the cost of providing services. For example, capital assets are acquired at one time but subsequently are used to provide services for many years afterwards. Including their cost in the cost of providing services is more informative if the capital assets are measured at their initial amounts. Such initial amounts for capital assets are based on the actual transactions in which the assets were acquired, rather than on a hypothetical transaction on a particular date. Depreciation allocates those initial amounts to each of the years during which the capital assets are used to provide services.

On the other hand, remeasured amounts are well suited to achieving the objectives related to financial position. For example, a remeasured amount for assets that will ultimately be converted to cash, such as many investments, will present a clear picture of a government's financial health at present and the resources at its disposal for providing services or satisfying obligations.

## Measurement Attributes

A "measurement attribute" is the particular characteristic of an asset or liability that is being measured using one of the two measurement approaches. **The GASB is proposing four measurement attributes—*historical cost, fair value, replacement cost, and settlement amount.*** Historical cost can be used to measure only initial amounts, but the other three can be used to measure either initial amounts or remeasured amounts.

The historical cost of an asset is the price that *actually* was paid to acquire it. For a liability, it is the proceeds *actually* received when the liability is incurred. Consistent with the initial amount measurement approach, historical cost is particularly suitable for supporting the assessment of cost of services but less useful for assessing a government's financial wherewithal for providing services in the future or meeting its obligations. (See paragraphs 32–34 of the Exposure Draft.)

Fair value is the price that *would be received to sell* an asset or *to transfer* a liability on a given date. This definition of fair value requires that the sale or transfer be an “orderly transaction” between “market participants.” (The definition of fair value is discussed beginning on page 8 of this supplement.) Fair value is considered an “exit price” because it is based on the selling of an asset or transfer of a liability, rather than on acquiring an asset or incurring a liability (an “entry price”). Although exit and entry prices are sometimes identical (this is the case, for instance, on a stock exchange), they may not be the same. (See paragraphs 35 and 36 of the Exposure Draft.)

Replacement cost is the price that *would be paid to acquire* an asset (an entry price) with the same potential for providing services on a given date. Consequently, replacement cost is suitable as an attribute for measuring assets that can be used for providing services, but not for assets that will be converted to cash. Replacement cost is based on the notion that an asset of equal service potential would be acquired in an orderly transaction. (See paragraphs 37 and 38 of the Exposure Draft.)

A settlement amount is how much *could be received* for an asset or *could be paid* to satisfy a liability. In this way, it appears similar to fair value. However, fair value is based on a market in which similar assets and liabilities are being routinely bought and sold, whereas a settlement amount is not based on such an “active market.” Rather, it is based on a transaction with a specific buyer or creditor. (See paragraphs 39 and 40 of the Exposure Draft.)

## **Alternative View**

One member of the GASB disagrees with the assertion in the Exposure Draft that initial amounts are consistent with the objective of providing information necessary to assess interperiod equity. This member believes that interperiod equity has meaning mainly to the extent that the cost of services represents the economic value (that is, a current, remeasured value) of the resources used to provide those services. Initial values, in contrast to remeasured values, provide no indication of the economic sacrifice incurred by current taxpayers or to be demanded of taxpayers in the future.

Furthermore, this member disagrees with the notion that fair value is not appropriate for measuring capital assets because it is an exit price and government capital assets are generally held for providing services and not sold. This member believes that a current value such as fair value would better inform considerations of whether governments should hold onto their capital assets and continue to use them as they do, or instead exchange them for other assets or use them in other ways that would be more cost beneficial.

This member believes that the Concepts Statement overstates the virtues of initial amounts and understates the advantages of remeasured amounts and, consequently, will discourage future standards setters from requiring governments to present—either in the basic financial statements or as supplementary disclosures—information that is necessary to assess interperiod equity and that is genuinely decision-relevant.

## Summary of Proposals

- Assets and liabilities can be measured in one of two ways—based on (1) their initial amount at the time they are acquired or incurred or (2) a remeasured amount as of the date of the financial statements.
- There are four attributes of assets and liabilities upon which their measurement can be based—their historical cost, fair value, replacement cost, or settlement amount.

### Questions for Users about Measurement Concepts

1. *Do you agree or disagree with the GASB's proposal that assets and liabilities should be measured as either initial amounts or remeasured amounts? Why do you agree or disagree?*
2. *Do you agree or disagree that a cost of services that reflects initial amounts is more useful for assessment of interperiod equity than a cost of services that reflects remeasured amounts? Why do you agree or disagree?*
3. *Do you agree or disagree that fair value generally is not suitable for assets that will be used directly to provide services? Why do you agree or disagree?*
4. *Do you agree or disagree with the GASB's four proposed measurement attributes? Why do you agree or disagree?*

## FAIR VALUE

This section of the plain-language supplement addresses the GASB's Preliminary Views on fair value. The Preliminary Views on fair value is interrelated with the Exposure Draft of measurement concepts because, as discussed above, fair value is one of four proposed measurement attributes. The Preliminary Views builds on that concept by proposing how fair value should be measured, which types of assets and liabilities should be measured at fair value, and what note disclosures should be provided with fair value measures.

This section is organized into four parts. Each addresses a major aspect of the GASB's proposals—how fair value should be defined, how it should be measured, which assets and liabilities it should be applied to, and what information about fair value should be disclosed in the notes to the financial statements.

## Definition of Fair Value

Fair value is a measurement attribute that has been used for many years in governmental accounting to measure most investments and some other assets. The definition of fair value that is presented in both the Exposure Draft and Preliminary Views is fundamentally consistent with the definition upon which the GASB's existing fair value standards are based. However, the proposed definition is more precise in its terminology and the Preliminary Views provides more explanations (see paragraph 20 of Chapter 1 of the Preliminary Views):

**Fair value is 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. As such, fair value is an exit price. The market to which the definition of fair value refers is the principal market for the asset or liability or, when there is not a principal market, the entity's most advantageous market. For nonfinancial assets, the price should represent the value of the asset at its highest and best use as determined by market participants. The highest and best use notion takes into account uses that are physically possible, legally permissible, and financially feasible. For liabilities, the price should take into consideration the credit standing of the entity. Multiple valuation techniques may be used to measure fair value.**

This definition is more specific than the one found in GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*: "The amount at which a financial instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale" (paragraph 22). The change in language to "an orderly transaction between market participants" is intended to emphasize the GASB's view that fair value is a market-based measure. In other words, fair value should be objectively based on market conditions and relevant factors. In light of the emphasis on markets, this new definition continues by explaining what the GASB means by a "market."

Another notable change in the proposed definition is the focus on a price to *sell* an asset or *transfer* a liability, rather than on an exchange. The proposed definition emphasizes that fair value is an *exit price*, whereas the existing definition is unclear as to whether fair value is a seller's price or a buyer's price, which sometimes may be significantly different. The use of "measurement date" in the new definition also is more precise than "current" in the existing definition. The initial measurement date is the date of the transaction, and subsequent measurement dates are the dates of the financial statements in which the fair value is reported.

Lastly, the Preliminary Views clarifies that the fair value of a nonfinancial asset—such as equipment or a building—is based on that asset's "highest and best use." Unlike many investments, nonfinancial assets generally are not traded on exchanges from which a price can be determined based on a large number of similar transactions. The GASB is proposing that if governments were required to use fair value to measure nonfinancial assets, the measurement would reflect the maximum economic return that a government

could generate with the asset. (Other than those that meet the definition of an investment [see page 12 of this document], the GASB is not proposing that nonfinancial assets be measured at fair value.)

The notion of highest and best use is not unlimited—a government generally would not be able to value its city hall as if it could be converted into an apartment or office building, if the current zoning does not allow for such conversions. The Preliminary Views clarifies that highest and best use is constrained by the boundaries of what is physically possible, allowable under current laws, and financially feasible. Furthermore, the concept of highest and best use is limited by the laws in place as of the measurement date, rather than what the laws might be if the government changed them.

### **Summary of Proposals**

- Fair value represents the exit price for selling an asset or transferring a liability in an open and active market.
- If fair value is used to measure nonfinancial assets, the fair value is based on their highest and best use that is physically possible, legally permissible, and financially feasible.

### **Questions for Users about the Definition of Fair Value**

5. *Do you agree or disagree with the GASB’s proposed definition of fair value? Why do you agree or disagree?*
6. *Do you agree or disagree with the GASB’s proposal that, if fair value were used to measure a nonfinancial asset, the fair value should be based on its highest and best use? Why do you agree or disagree?*

### **How Fair Value Would Be Measured**

The GASB’s preliminary view is that **there are three acceptable “valuation approaches” to measuring fair value—market, cost, or income.** (See paragraphs 28–33 of Chapter 2 of the Preliminary Views.)

- Determining fair value with the “market approach” utilizes information resulting from market transactions for identical or comparable assets or liabilities.
- The “cost approach,” on the other hand, bases fair value on the amount necessary to replace an asset’s present capacity for providing service.
- The “income approach” calculates fair value by converting future amounts to a single current amount. For instance, a government might project cash flows from an asset and discount them to their present value.

If market information that qualifies as a Level 1 input (see below) is available for measuring fair value, a government would employ the market approach rather than the cost or income approach.

The GASB’s preliminary view is that a variety of “valuation techniques” for establishing fair value could be acceptable, depending on the specific circumstances of the measurement, as long as they meet two criteria. First, **the valuation technique that a government employs should be consistent with the three valuation approaches.** Second, **the valuation technique should be based on “observable inputs” as much as possible.**

Inputs are the assumptions that market participants make when deciding on the price for an asset or liability, such as the degree of risk they perceive. Observable inputs are those that are readily accessible to the public, such as available market data based on actual transactions, whereas “unobservable inputs” are not.

The Preliminary Views discusses a three-level hierarchy of inputs into the measurement of fair value. (See paragraphs 34–39 of Chapter 2 of the Preliminary Views.) Level 1 and Level 2 inputs are observable and Level 3 inputs are unobservable. (This hierarchy has been in use in the private sector since 2006 under the standards of the Financial Accounting Standards Board.)

- Level 1 inputs are quoted prices from markets with many transactions for *identical* assets and liabilities. Level 1 inputs are derived directly from the market and need not be adjusted in any way.
- Level 2 inputs are either (1) directly observable, like quoted market prices, but for *similar* assets and liabilities, or (2) correlated or corroborated from observable market information. Generally, Level 2 inputs should not be used unless Level 1 inputs are unavailable.
- Level 3 inputs are assumptions a government develops based on the best information available to it. Generally, Level 3 inputs should not be used unless Level 1 and Level 2 inputs are unavailable.

The distinction between the three levels speaks to the reliability of the measurement of an asset or liability’s fair value. Observable inputs are innately more reliable than unobservable inputs because observable inputs are easier to verify. Level 1 inputs generally are more reliable than Level 2 inputs because Level 1 inputs are drawn directly from active markets without adjustment. However, if Level 1 inputs are based on transactions that are not orderly, Level 2 inputs may be more reliable in those circumstances.

### **Investments in Certain Entities That Calculate Net Asset Value per Share**

Some governmental entities—particularly pension funds and endowments—hold investments for which there is not a “readily determinable fair value.” These investments—sometimes called “alternative investments”—frequently take the form of shares in hedge funds and limited partnerships. It is difficult to measure their fair value because their shares are not traded openly, or the ability to sell shares is limited to a degree that there are few or no observable inputs. The question arises, “How does a government place a fair value on such investments for financial reporting purposes?”

The GASB’s preliminary view is that **governments in these circumstances should be allowed to value their investment using “net asset value per share”** (or its

equivalent). (See paragraphs 43 and 44 in Chapter 2 of the Preliminary Views.) Net asset value per share is an amount provided by a hedge fund, for instance, based on its measurement of the fair value of its assets and liabilities. It essentially equals assets minus liabilities (net assets) divided by the total number of shares in the fund. Multiplied by the number of shares a government owns, it produces a value for the government's investment that can be reported in its financial statements. This process is referred to as a "practical expedient," and it is already used by some governmental entities.

### Summary of Proposals

- There are three valuation approaches—market, cost, and income. Valuation techniques should be consistent with those valuation approaches and rely on observable inputs as much as possible.
- Inputs into the measurement of fair value should be organized into a three-level hierarchy based on their inherent reliability. Level 1 inputs, if available, are preferable to Level 2 inputs, which in turn are preferable to Level 3 inputs.
- Governments with investments in hedge funds and certain other entities that calculate net asset value per share should be allowed to use a practical expedient to determine the value of those investments.

### Questions for Users about the Measurement of Fair Value

7. *Do you agree or disagree with the GASB's proposals regarding valuation approaches and techniques? Why do you agree or disagree?*
8. *Do you agree or disagree with the GASB's proposal to categorize inputs into Level 1, Level 2, or Level 3? Why do you agree or disagree?*
9. *Do you agree or disagree with the GASB's proposal to allow governments to use a practical expedient to value investments in certain entities that calculate net asset value per share? Why do you agree or disagree?*

### How Fair Value Would Be Applied

The GASB's preliminary view is that **investments generally should be measured at fair value**. (See paragraphs 14–16 of Chapter 3 of the Preliminary Views.) Fair value is well suited for assessing a government's financial position. Because investments are held to generate cash or will ultimately be converted to cash, measuring them at their current value as of the date of the financial statements presents a clear picture of the resources a government has at its disposal for providing services or satisfying obligations.

At present, most investments already are required to be reported at their fair value in the financial statements of state and local governments. A question that is routinely raised, though, is how one knows if an asset is an investment.

## Definition of an Investment

The GASB has proposed the following definition of an investment: **An investment is a security or other asset that a government holds primarily for the purpose of income or profit, and its present service capacity is based solely on its ability to generate cash, to be sold to generate cash, or to procure services for the citizenry.** (See paragraphs 2–4 of Chapter 3 of the Preliminary Views.)

The principal implication of this proposed definition is that some items not commonly reported as investments at present would henceforth be considered investments and therefore governments would have to measure their fair value. It also is possible that some assets governments are currently reporting as investments would no longer be considered investments. Paragraphs 6–13 of Chapter 3 of the Preliminary Views present several examples of how this proposed definition of an investment might be applied, including:

- A state owns royalty interests in oil and gas properties for the purpose of raising funds to finance public education—*these would be considered investments*
- A state owns land with timber resources, the rights to some of which it occasionally sells to raise money for natural preservation; the land and its timber are held for preservation and recreation purposes and not primarily to raise cash—*not investments*
- A city holds assets in a reserve; the assets may be invested or sold to raise cash to make bond payments, if necessary—*investments*
- A housing authority holds mortgage loans receivable related to a program to encourage homeownership—*not investments*.

## Exceptions to Fair Value

Under existing standards, several types of investments are not required to be reported at fair value. The GASB's preliminary view is that **the following exceptions to the requirement to measure investments at fair value should be continued** (see paragraph 19 of Chapter 3 of the Preliminary Views):

- Investments with a maturity of one year or less at the time of purchase, such as money market investments
- Investments in 2a7-like external investment pools (a type of government-sponsored, short-term investment pool)
- Most investments in life insurance
- Investments in common stock that meet the criteria for applying the equity method of accounting (briefly, an investment in voting stock that gives a government the ability to exercise significant influence over the company's operating and financial policies)
- Nonparticipating interest-earning investment contracts (those with redemption terms that are not affected by market rates, such as a typical certificate of deposit)
- Unallocated insurance contracts (a type of investment that pension plans enter into with insurance companies)

- Synthetic guaranteed investment contracts that are fully benefit responsive (an explanation of the meaning of “fully benefit responsive” can be found in paragraph 67 of Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*).

### **Use of Acquisition Value**

Fair value is an exit price—the price a government would receive if it sold an asset. Acquisition value, on the other hand, is an entry price—the price that would have to be paid to acquire a similar asset with similar service capacity. Acquisition value (associated with assets) is a replacement cost measurement attribute (as described on page 6 of this supplement). The GASB’s preliminary view is that **certain assets currently required to be measured at fair value should be measured at acquisition value instead** (see paragraphs 23 and 24 of Chapter 3 of the Preliminary Views):

- Capital assets received in a nonexchange transaction (such as capital assets received by donation)
- Works of art and historical treasures received by donation
- Certain assets received in nonmonetary transactions.

### **Transaction Costs**

At present, defined benefit pension plans and retiree health insurance plans subtract related transaction costs—such as brokerage commissions—when measuring the fair value of their investments, if those costs are significant. However, the GASB is proposing that transaction costs be reported as expenses when incurred and not netted against the fair value of investments. Subtracting transaction costs results in understating both the value of investments and the amount of expenses. Therefore, it is the GASB’s preliminary view that **fair values reported by these plans should no longer be adjusted for transaction costs**. (See paragraphs 25 and 26 of Chapter 3 of the Preliminary Views.)

### **Summary of Proposals**

- Investments should be measured at fair value, with certain exceptions.
- An investment is an asset held primarily for the purpose of income or profit; its present service capacity is based solely on its ability to generate cash, to be sold to generate cash, or to procure services for the citizenry.
- Certain assets, such as donated capital assets, should be measured at acquisition value instead of fair value.
- Fair value should not be adjusted for transaction costs.

### Questions for Users about the Application of Fair Value

10. *Do you agree or disagree with the GASB's preliminary view that investments generally should be measured at fair value? Why do you agree or disagree?*
11. *Do you agree or disagree with the GASB's proposed definition of an investment? Why do you agree or disagree?*
12. *Do you agree or disagree with the GASB's preliminary view that fair value should not be adjusted for transaction costs? Why do you agree or disagree?*

### How Fair Value Would Be Disclosed

As described earlier, the reliability of inputs that a government employs when measuring fair value may vary considerably. Level 1 inputs are more reliable than Level 2 inputs, which in turn are more reliable than Level 3 inputs. In order for users to understand and use fair value information, that information should be a reliable measurement of an asset's or a liability's actual value—it should be “representationally faithful.” The GASB believes that **to produce a representationally faithful measure, governments should disclose in the notes to the financial statements the methods and assumptions they employ when measuring fair value.** Furthermore, **there should be greater disclosure for measurements that employ Level 3 inputs** because they are not observable and cannot be corroborated by observable market data.

### Level of Detail for Disclosures

The GASB's preliminary view is that **disclosures should be organized by type or class of asset and liability.** In other words, it would not be sufficient in general for a government to simply disclose its investments in the aggregate. The extent to which those types or classes are disaggregated, though, depends on a variety of factors, such as:

- The nature, characteristics, and risks of the assets or liabilities (for instance, investments in corporate stock would be disclosed separately from commercial paper)
- Which level of inputs are used to measure the fair value of the assets or liabilities (there would be greater disaggregation for assets and liabilities measured using Level 3 inputs)
- If the standards specifically require separate disclosure of an asset or liability (such as derivatives)
- The value of the assets or liabilities measured at fair value relative to all assets and liabilities. (Generally, the larger the proportion of assets and liabilities measured at fair value, the more important fair value measurements are to assessing a government's finances and, therefore, the greater the need for disaggregation.)

## Proposed Disclosures

Under current accounting standards, governments are required to disclose how they arrived at their measures of fair value if they are not based on quoted market prices. **The GASB is proposing a more detailed set of disclosures that take into account the levels of inputs a government uses to measure fair value and their inherent degrees of uncertainty and subjectivity.** Governments would disclose the following:

- The fair value amounts as of the date of the financial statements, and the levels of inputs used to determine them (Illustration 1 in Appendix B of the Preliminary Views shows this in a narrative form; Illustration 2 presents the disclosure in a tabular format)
- The valuation techniques and inputs (assumptions) used
- Any changes in techniques and inputs that had a significant impact on the measurement of fair value and the reasons for the changes
- Additional quantitative information describing the nature of significant Level 3 inputs, if any, used to measure fair value (this could be done in narrative form, or in a table like that illustrated on page 35 of the Preliminary Views)
- A narrative description of the degree to which fair value measurements are sensitive to changes in Level 3 inputs.

The amount of disclosure is greater when Level 3 inputs are used because they are unobservable and, consequently, more difficult for a user to objectively verify. In the absence of inputs that users can observe and verify on their own, the disclosures would give users the information they need to evaluate the measurement techniques used and the resulting fair value measures.

Likewise, the GASB is proposing additional disclosures for investments in certain entities that calculate net asset value per share (alternative investments). As described on page 11 of this supplement, these investments do not have a readily determinable fair value and, therefore, the GASB believes governments should be able to use a practical expedient to value them. However, net asset value per share is often more uncertain and subjective than the fair value measurements of other assets and liabilities.

Consequently, it is the GASB's preliminary view that **additional disclosures are necessary for certain alternative investments** (entities that calculate net asset value per share or its equivalent), even if the practical expedient has not been used. These disclosures would include the following for each type of alternative investment (see the illustration on pages 36 and 37 of the Preliminary Views):

- Fair value amounts as of the date of the financial statements
- Significant investment strategies of the entities in which the government has invested
- When the entities are expected to liquidate the assets underlying the investment
- The amount of any related commitments the government has, for which it has not set aside resources (unfunded commitments)
- Terms and conditions under which the government may redeem the investments
- Restrictions preventing the government from redeeming an investment that otherwise is redeemable, and when the restriction is expected to end (if the government does not

know when the restriction will end, it should disclose that fact and state how long the restriction has been in effect)

- Other significant restrictions on the government’s ability to sell the investments.

### **Summary of Proposals**

- Governments would disclose:
  1. Amounts of assets and liabilities measured at fair value by type or class and by input Levels 1, 2, or 3
  2. Techniques and inputs used to measure fair value and changes in techniques and inputs that have a significant impact on measurement
  3. Additional information about the use of Level 3 inputs, including the degree to which fair value measurements are sensitive to changes in Level 3 inputs
  4. Additional information about certain alternative investments, including limitations on redeeming or selling the investments.

### **Question for Users about Fair Value Disclosures**

**13. Which of the proposed fair value disclosures (items (1) through (4) above) will be valuable to the decisions you make or the assessments you perform? How would you use the information from those disclosures you consider valuable?**

### **WHAT INFORMATION DOES THE GASB NEED TO PROCEED?**

When the GASB sets standards and establishes concepts, a crucial part of its “due process” activities is the publication of documents for public discussion and comment. The GASB relies on the comments of the people who prepare and audit financial statements to assess the technical accuracy and appropriateness of potential approaches to addressing accounting and financial reporting issues.

The users of financial statements, on the other hand, are in the best position to help the GASB understand whether or not the information that would result from the proposals would be important for fulfilling their need for governmental financial information. The substance of the comments from each of the GASB’s constituents is more important to the GASB’s deliberations than the total number of people for or against a certain proposal. An Exposure Draft is not an opinion poll, and the GASB’s ultimate decisions are not necessarily those with the most popular support.

You can help the GASB by reviewing the proposals and answering the questions posed throughout this supplement. You are also invited to review and comment on the related Exposure Draft and Preliminary Views that the GASB is issuing simultaneously.

## HOW CAN YOU SHARE YOUR OPINIONS WITH THE GASB?

It is essential to the GASB to receive feedback from users like you, in response to the questions presented above. The GASB is conducting a webinar summarizing the proposals and providing an opportunity for you to ask questions on September 5, 2013, at 3:00 p.m. Eastern time. The webinar will be followed immediately by a web-based survey allowing you to answer the questions and offer your views. The webinar can be viewed and the survey completed on that date or on any day following through the September 30 comment deadline.

If you would prefer to submit written comments to the GASB about the views expressed in this document, there are two ways you may do so:

- By email—send your comments to [director@gasb.org](mailto:director@gasb.org)
- By traditional mail—include your comments in a letter and mail to:

Director of Research and Technical Activities  
Project Nos. 3-20E and 26-5P  
Governmental Accounting Standards Board  
401 Merritt 7, PO Box 5116  
Norwalk, CT 06856-5116

*Submissions are requested by September 30, 2013.*

The GASB also is holding a public hearing in Flushing, New York, on November 1, 2013, beginning at 8:30 a.m. Eastern time. If you wish to speak at the hearing, you should notify the GASB of your intent in writing and submit a copy of your comments, using the email or postal address above, no later than September 30. You can testify at the hearing in person or via telephone. Please read the participation requirements in the notice of public hearing in the Exposure Draft and Preliminary Views.