Accounting and Financial Reporting for Cash and Investments

Cash Management and Investment of Public Funds

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GASB Statement No. 31
Key Provisions

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

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

Exceptions to Fair Value Accounting and Reporting (cont.)

- Entities other than pools
  - Money market instruments with *original* maturity of one year or less – cost / amortized cost
    - Commercial paper
    - Banker’s acceptances
    - T-bills
    - Does not include asset-backed securities, derivatives and structured notes
  - Non-participating interest-earning investment contracts - cost
GASB Statement No. 31
Specific Reporting Requirements

- Changes in fair value reported when they occur
- NO separation of realized vs. unrealized
  - Exception for external investment pools
  - Separate note disclosure allowed for both
- Operating statement implications

GASB Statement No. 31
Required Note Disclosures

- Methods/assumptions used to estimate fair value
- Amortized cost option
- Definitions of realized vs. unrealized gains/losses
- Income from one fund assigned to another
- Various external pool disclosures
GASB Statement No. 3

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

GASB 40 – Deposit/Investment Risk Disclosures

- Modifications of GASB Statement No. 3:
  - Custodial credit risk disclosures for deposits and investments for Categories 1 and 2 eliminated
    - Only Category 3 disclosures required – uninsured and uncollateralized deposits / investments that are uninsured, unregistered or held by counterparty or counterparty’s agent, but not in government’s name
  - Window-dressing disclosures eliminated
  - Definition of counterparty changed – party that pledges securities or collateral or buys or sells securities from government
GASB 40–Deposit/Investment Risk Disclosures (Cont.)

- Investment disclosures should be aggregated by investment type – do not aggregate dissimilar items – consider risk profiles of investments.
- Disclosure level is usually for the primary government (PG).
- Added disclosure if risks are greater for business-type activities, governmental activities, major funds, aggregate nonmajor funds, etc., than for PG as a whole.

GASB 40–Deposit/Investment Risk Disclosures (Cont.)

- Disclosures for Component Units may be necessary – follow GASB Statement No. 14 requirements.
- Disclosures may be made by portfolio.
GASB 40–Deposit/Investment Risk Disclosures (Cont.)

- Disclosures should be made for deposit & investment policies related to risks in GASB 40
  - Do not reprint entire policy – summarize
  - Disclosure only for risks government is exposed to
  - If no policy for a risk – disclose this fact
  - No change in requirement to disclose legally authorized investments, even if policy is more restrictive
  - Should be a formally adopted policy – usually by governing board – for informal practices, disclose that there is no policy

GASB 40–Deposit/Investment Risk Disclosures (Cont.)

- Disclosures for specific risks - credit risks
  - Disclose credit rating or that investment is unrated
  - If split ratings - disclose
  - Does not apply to US government or explicitly guaranteed investments
  - Does apply to implicit guarantees (Fannie Mae, Freddie Mac)
  - Disclose pool ratings, not underlying investments (NCCMT Cash – AAAm; Term & STIF– unrated)
  - Investments may be aggregated by rating categories
  - If security is unrated, but issuer is rated – no rating
GASB 40–Deposit/Investment
Risk Disclosures (Cont.)

- Disclosures for specific risks - custodial credit risks – previously discussed
  - Disclose amounts at risk from Category 3 and how at risk
  - Discussion of categories of risk omitted
  - Disclosure not required for investment pools and mutual funds
  - Disclosure required for unsecured portion of repurchase agreements

GASB 40–Deposit/Investment
Risk Disclosures (Cont.)

- Disclosures for specific risks - concentration of credit risk
  - Disclose by amount & issuer investments in any 1 issuer of 5% or more of total investments (not including deposits) based on level of detail discussed previously
  - US treasuries & US government-guaranteed investments are excluded from this requirement
  - Investments in mutual funds (NCCMT) and investment pools (STIF) are excluded from this requirement
  - Repurchase agreements – underlying collateral – if US government-guaranteed, not a problem
• Disclosures for specific risks - Foreign currency risk
  – Not normally applicable in NC
  – Eurodollar CD’s

• Disclosures for specific risks - interest rate risk
  – Disclose information by investment type using 1 of 5 methods
    • Segmented time distribution
    • Specific identification
    • Weighted average maturity
    • Duration
    • Simulation model
  – Use method closest to how risk is managed
  – Disclose assumptions about timing of cash flows (calls), interest rates, etc.
  – Not required for deposits and NCCMT Cash Portfolio
GASB 40–Deposit/Investment
Risk Disclosures (Cont.)

• Disclosures for specific risks - interest rate risk (cont.)
  – Interest rate disclosure methods may be changed – change in accounting principle
  – Separate methods may be used for short & long-term investments
  – For variable rate investments the maturity is the next reset date
  – Weighted average maturity disclosed for STIF & Term Portfolio

GASB 40–Deposit/Investment
Risk Disclosures (Cont.)

• Disclosures for specific risks (cont.):
  – Disclose for investments with fair values that are highly subject to changes in interest rates
    • Terms not otherwise disclosed – imbedded options, coupon multipliers, reset dates, etc.
    • Disclosures for examples may be aggregated
  
• Numerous examples given in statement
• No disclosures required for legal, liquidity, and inflation risks
Policy Disclosures

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

Other Deposit/Investment Presentations and Disclosures

- Discretely presented component unit considerations
  - Disclosures made when material to primary government
  - Must be distinguished from the primary govt.
- Reconciliation to balance sheet optional
- Cash flow statement reconciliation to balance sheet NOT appropriate for notes
GASB 53 – Accounting and Financial Reporting for Derivatives

- Expands on existing guidance
- Supersedes FASB 52, 80, as well as TB 2003-1
- Governments generally report derivatives at fair value

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

- Exclusions:
  - Normal purchases and sales contracts
  - Insurance contracts accounted for under GASB Statement No. 10
  - Certain financial guarantee contracts
  - Certain contracts that are not exchange-traded
  - Loan commitments
GASB 53 – A and FR for Derivatives (cont.)

• Definitions
  – Definitions from TB 2003-1 and FASB 133 continued
    • Settlement factors (reference rates, notional amounts, etc.)
    • Leverage
    • Net settlement
  – Supporting paragraphs modified

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

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

- Management’s objective is to establish a hedge
- Hedging instrument is a derivative
- Hedging derivative associated with hedgeable item

- Hedge not effective — fair value accounting — generally gains and losses accounted for in investment income
- All hedges evaluated annually for effectiveness
- Evaluation may be for current year or for inception to date
- Basis swaps are never hedges (if that is all that is being changed)
- For effective hedges — recognize fair value changes as deferred items

Methods for evaluating hedge effectiveness

- Consistent critical method
- Quantitative techniques
  - Synthetic instrument
  - Dollar-offset
  - Regression
  - Other quantitative methods
GASB 53 - Main Note Disclosures

- Summary of derivative instrument activity
- Disclosures may be aggregated for similar derivative types
- Information organized by governmental, business-type and fiduciary activities
- Information divided into 3 broad categories: fair value hedges, cash flow hedges, and investment derivative instruments

GASB 53 - Summary of Derivative Instrument Activity

- Notional amount
- Changes in FV during year and locations in the financial statements where those FV changes are reported
- FV at end of the reporting period and the locations in the financial statements where those FVs are reported
- If derivative instruments reported other than at quoted market prices, disclose methods and assumptions used to estimate FV
- FV of derivative instruments reclassified from a hedging derivative to an investment derivative instrument
- Disclosure of deferral amount that was reported in investment income
GASB 53 - Hedging Derivative Instruments

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

GASB 59 – Financial Instruments Omnibus

- To use amortized cost – 2a7-like funds must follow ALL of the 2a7 requirements including having a separate board
- Interest rate risk disclosures are only made for bond funds and other debt pools that are not 2a7-like pools or 2a7 funds
- Unallocated insurance contracts – treat as interest-earning investment contracts (follow requirements for participating & non-participating)
- NCGA Statement 4 (guarantees of the indebtedness of others) amended to limit to debt instruments that are not derivatives entered into primarily for obtaining income or profit – GASB Statement 70 makes no real changes to this provision
GASB 59 – Financial Instruments Omnibus (cont.)

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

GASB 28 – Securities Lending

- This class omits discussion of accounting requirements for securities lending and reverse repurchase agreements
  - Securities lending requirements in GASB 28
  - Reverse repurchase agreements in GASB 3
  - Neither authorized for local governments under G.S. 159-30
GASB 64 – Application of Hedge Acctg. Termination Provisions

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

GASB 64 – Application of Hedge Acctg. Termination Provisions

- No, hedging relationship continues when swap counterparty or swap counterparty credit support provider replaced with an assignment or in-substance assignment
- Assignment – swap counterparty or counterparty credit support provider replaced, but no other changes
- In-substance assignment – party is replaced, but the new agreement is essentially the same as the old agreement and any payment was established under the old agreement
- Implementation date – fiscal years beginning after 6/15/11
GASB Statement 72

Fair Value Measurement and Application

Overview

- **What:** The GASB issued Statement 72 to update the existing standards on fair value (primarily Statement 31)
- **Why:** Review of existing standards found opportunities to improve the measurement of resources available to governments, and to increase comparability and accountability
- **When:** Effective for fiscal years beginning after June 15, 2015
Fair Value Definition

- The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.
  - An exit price
- Other characteristics of fair value
  - Market-based
    - Based on a government’s principal or most advantageous market
- Fair value is not an option – it is required

Valuation Techniques

- Apply valuation technique(s) that best represents fair value in the circumstances
  - Market approach – Using prices and other relevant information generated by market transactions involving identical or similar assets or liabilities
  - Cost approach – Amount that would be required currently to replace the service capacity of an asset
  - Income approach – Converts expected future amounts (for example, cash flows) to a single current amount (that is, discounted)
- Revisions due to a change in valuation technique(s) are considered a change in accounting estimate
Inputs

- Maximize use of relevant observable inputs and minimize use of unobservable inputs
- Inputs should be consistent with the characteristics of the asset or liability
- Based on bid and ask prices
- **Level 1**: quoted prices (unadjusted) in active markets for identical assets or liabilities, most reliable
- **Level 2**: quoted prices for similar assets or liabilities, quoted prices for identical or similar assets or liabilities in markets that are not active, or other than quoted prices that are observable
- **Level 3**: unobservable inputs, least reliable

Measurement—Net Asset Value Per Share (NAV)

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

- A security or other asset that a government holds primarily for the purpose of income or profit and with a present service capacity that is based solely on its ability to generate cash or to be sold to generate cash
  - Service capacity refers to a government’s mission to provide services
  - Held primarily for income or profit—acquired first and foremost for future income and profit

Fair Value Application

- Assets that meet the definition of an investment generally should be measured at fair value
  - Alternative investments
  - Equity securities, stock warrants, and stock rights that do not have readily determinable fair values—provided such investment-types are not reported according to the equity method
  - Commingled investment pools that are not government-sponsored
  - Invested securities lending collateral
  - Intangible assets
  - Land and land rights
  - Real estate
  - Lending assets
  - Natural resource assets
Investments Not Reported at Fair Value

- Money market investments and participating interest-earning investment contracts that have a remaining maturity at time of purchase of one year or less, reported by governments other than external investment pools
- Investments in 2a7-like pools
- Investments in life insurance - investments in life settlement contracts, however, should be at fair value
- Investments in common stock that meet the criteria for applying the equity method
- Non-participating interest-earning investment contracts
- Unallocated insurance contracts
- Synthetic guaranteed investment contracts that are fully benefit responsive

Application of Acquisition Value

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

- The following information for each class or type of assets and/or liabilities measured at fair value should be disclosed:
  - The fair value measurement at the end of the reporting period and for nonrecurring fair value measurements, the reasons for the measurement
  - The level of the fair value hierarchy within which the fair value measurements are categorized in their entirety (Level 1, 2, or 3)
  - A description of the valuation technique(s)

Level 3 and NAV

- For fair value measurements categorized within Level 3 of the fair value hierarchy
  - The effect of those investments on investment income for the reporting period
- Disclosures for investments in certain entities that calculate NAV per share (or its equivalent)
  - Information that helps users of its financial statements to understand the nature and risks of the investments
  - Information on whether the investments are probable of being sold at amounts different from net asset value per share (or its equivalent)
GASB Exposure Draft

Accounting and Financial Reporting for Certain External Investment Pools

External Investment Pools

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

- Current standards allow pools that are considered to be 2a7-like to report investments at amortized cost rather than fair value
  - The SEC recently made significant changes to Rule 2a7
  - Concerns were raised regarding the cost-benefit of government pools applying the revised Rule 2a7 provisions
- The project is considering criteria independent of Rule 2a7 that could be applied by external investment pools to determine when a cost-basis can be applied to investments.
  - The current 2a7 provisions and other regulatory provisions are being used as starting point.
- This project would not apply to the NCCMT Cash (Government) Portfolio and the NCCMT Term Portfolio
  - The Term Portfolio is registered with the SEC and is a bond fund
  - The Cash Portfolio is registered with the SEC - not currently affected by the GASB’s proposed changes – would have to de-register to benefit from any changes

Proposal Summary

- GASB separated accounting and financial reporting from SEC requirements
- ED driven by amortized cost approximating fair value
- Patterned after 2010 SEC regulations for 2a7 funds
- Some of the 2010 regulations were excluded (e.g., stress testing) if they were operational in nature
- Significant instances of noncompliance would require a switch to fair value accounting
  - Professional judgment required
  - Significant means material
  - Switch back to amortized cost possible in future periods
Tentative Criteria Categories

- Pool should transact with participants at a stable net asset value (NAV) – if NAV floats an external investment pool should use fair value
- Portfolio maturity limits
- Portfolio quality requirements
- Portfolio diversification requirements
- Portfolio liquidity limits
- Shadow pricing requirements

Proposed Implementation

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

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