Memorandum

GASAC Meeting

February 21–22, 2013

To: GASAC Members

From: Randy Finden, Deborah Beams, Ashley Weller, and Janalyn Guo

Date: January 28, 2013

C: GASB Board, Dave Bean, and Fair Value Measurement and Application task force

Re: Fair Value Measurement and Application Project

INTRODUCTION

This paper summarizes the major tentative decisions made by the Board regarding the Fair Value Measurement and Application project since the November 2012 Governmental Accounting Standards Advisory Council (GASAC) meeting. Disclosures related to fair value are currently being deliberated by the Board and are also presented in this paper. The purpose of this paper is to obtain GASAC member feedback on the major tentative decisions reached by the Board since the last GASAC meeting, to consider fair value disclosures, and to determine whether there are additional issues that the Board should consider within the Fair Value Measurement and Application project.

MAJOR TENTATIVE DECISIONS

Since the last GASAC meeting, the Board has made the following major tentative decisions. Although this paper does not include a full discussion of these topics and the bases for the tentative decisions, we invite your comments on these proposals.

1. Lending Assets

    a. Lending assets (including mortgage loans) that are held primarily for the purpose of income or profit and have present service capacity that is based solely on their ability to generate cash, to be sold to generate cash, or to procure services for the citizenry, should be classified as investments.

b. Lending assets that meet the definition of an investment asset should be measured at fair value.

c. Specific guidance in Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, paragraph 42, and Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, paragraph 424, for mortgage loan investments held by public entity risk pools and insurance entities other than risk pools should be eliminated.

2. Donated capital assets should no longer be measured at fair value but should be measured at acquisition value. Acquisition value is a market-based entry price. An entry price is assumed to be based on an orderly transaction entered into on the acquisition date, representing the price that would be paid for acquiring similar assets having similar service capacity, or discharging the liabilities assumed as of the acquisition date.

3. Life Settlement Contracts and government-held life insurance have been deliberated. These are fairly complex instruments. Portions of a staff paper from the October 2012 Board meeting providing background and explanations of these arrangements are included in this paper as the Appendix.

   a. A life settlement contract has all of the following characteristics:

      1) The investor does not have an insurable interest in the insured (an interest in the survival of the insured, which is required for the issuance of an insurance policy).

      2) The investor provides consideration to the policy owner of an amount in excess of the current cash surrender value of the life insurance policy.

      3) The contract pays an investor the face value of the life insurance policy when the insured dies.

   b. Fair value should be the measurement basis of life settlement contracts that meet the criteria noted above.

   c. Life settlement contracts that meet the criteria above should be evaluated on an individual basis.

   d. Life settlement contracts should be accounted for as the net of the fair value of expected benefit payments less the fair value of future premiums.

e. Government-held life insurance contracts that are investments should continue to be measured at cash surrender value.

4. Natural resource assets *that are held as investments* will be measured at fair value.

DISCUSSION QUESTION

1. Do you agree with the Board's major tentative decisions on the following topics? Why or why not?

a. Lending assets

b. Donated capital assets

c. Life settlement contracts

d. Natural resources held as investments

DISCLOSURES

The Board is considering requiring fair value disclosures that are similar to what the FASB currently requires in Topic 820, *Fair Value Measurement.* Generally, those required disclosures fall into four main categories and should be disclosed in a tabular format. The main categories are as follows and are presented as discussion questions later in this paper:

1. Assets and liabilities measured at fair value
2. Information about fair value measurements categorized within Level 3 of the fair value hierarchy
3. Reconciliation of fair value measurements categorized within Level 3 of the fair value hierarchy
4. Fair value measurements of investments in certain entities that calculate net asset value per share (or its equivalent)

Note that the FASB literature currently provides for significantly more assets and liabilities (particularly with the fair value option) to be measured at fair value than the GASB literature. In the GASB literature, the liabilities most likely to be measured at fair value are derivative liabilities, such as an interest rate swap.

Assets and Liabilities Measured at Fair Value

The FASB requires disclosure of quantitative information for assets and liabilities reported at fair value. The fair value of such assets and liabilities should be grouped by class for similar instruments. The level of the fair value hierarchy within which the fair value measurements are classified also should be disclosed. While fair value yields quantitative results, the inputs into those results may be qualitatively different. Hence, inputs are placed into three levels: Level 1 inputs are quoted prices in active markets for identical assets. Levels 2 and 3 inputs are employed when Level 1 inputs cannot be. Level 2 inputs are observable inputs other than market prices. An example of a Level 2 input is the London Interbank Offered Rate that is incorporated as a variable payment rate in an interest rate swap. Finally, Level 3 inputs are not observable. An example is a long-dated interest rate swap that incorporates variable payment rates beyond which forward rates are available.

Table A, presented later in this paper, is an illustration showing fair value measurements grouped by both asset class and level of the fair value hierarchy.

DISCUSSION QUESTION

2. **Should the Board propose a disclosure requirement such as the illustration in Table A, which presents quantitative information for assets measured at fair value, separated by asset class and level of the fair value hierarchy the asset falls within? Why or why not? How might the disclosure be improved?**

Information about Fair Value Measurements Categorized within Level 3 of the Fair Value Hierarchy

The FASB requires additional information for fair value measurements categorized within Level 2 or Level 3 of the fair value hierarchy. For fair value measurements categorized within Level 2 or Level 3, the FASB requires that a description of the valuation technique used should be disclosed, as well as a description of the inputs used. For assets in Level 3, quantitative

information about the significant unobservable inputs also should be disclosed. Table B presents one way to disclose this information.

DISCUSSION QUESTION

3. **Should the Board propose a disclosure requirement such as the illustration in Table B, which presents additional information such as valuation techniques and unobservable inputs used for assets categorized in Level 2 or Level 3 of the fair value hierarchy? Why or why not? How might the disclosure be improved?**

Reconciliation of Fair Value Measurements Categorized within Level 3 of the Fair Value Hierarchy

Another FASB requirement for fair value measurements categorized within Level 3 of the fair value hierarchy is to provide a reconciliation from opening to closing balances of fair value measurements. This reconciliation includes the reason for changes in fair value measurements, as well as the classes of assets or liabilities that experienced those changes. An illustration of this requirement is presented in Table C.

DISCUSSION QUESTION

4. **Should the Board propose a disclosure requirement such as the illustration in Table C, which presents a reconciliation of opening balances to closing balances for assets classified within Level 3 of the fair value hierarchy? Why or why not? How might the disclosure be improved?**

Fair Value Measurements of Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)

The FASB provides a practical expedient for calculating the fair value of investments in certain entities that calculate a net asset value per share (or its equivalent). This guidance is primarily geared toward alternative investments, such as hedge funds, private equity, and limited partnerships. This guidance also is for investments in investment companies that do not have

readily determinable fair values. The practical expedient allows an entity to estimate the fair value of investments in such entities by using the net asset value per share. Disclosures are required to include information that would help users of the financial statements understand the nature and risks of the investments and whether the investments are probable of being sold at amounts different than the net asset value per share (or its equivalent). Table D presents minimum requirements to meet this objective.

DISCUSSION QUESTION

5. **Should the Board propose a disclosure requirement such as the illustration in Table D, which presents additional information for investments in entities that calculate net asset value per share (or its equivalent)? Why or why not? How might the disclosure be improved?**

ADDITIONAL ISSUES

The Board's deliberations on the Fair Value Measurement and Application project are nearing completion prior to the development of an Exposure Draft. After considering the major tentative decisions that the Board has already made, are there additional measurement and application issues that the Board should consider?

DISCUSSION QUESTION

6. **What additional issues, if any, should the Board consider?**

Table A

($ in millions)		Fair Value Measurements at the End of the Reporting Period Using			
	12/31/X9	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Gains (Losses)
Description					
Recurring fair value measurements					
Trading securities [a]					
Equity securities—real estate industry	$ 93	$ 70	$ 23		
Equity securities—oil and gas industry	45	45			
Equity securities—other	15	15			
Total trading securities	$ 153	$ 130	$ 23		
Available-for-sale debt securities					
Residential mortgage-backed securities	$ 149		$ 24	$ 125	
Commercial mortgage-backed securities	50			50	
Collateralized debt obligations	35			35	
U.S. Treasury securities	85	$ 85			
Corporate bonds	93	9	84		
Total available-for-sale debt securities	$ 412	$ 94	$ 108	$ 210	
Available-for-sale equity securities [a]					
Financial services industry	$ 150	$ 150			
Healthcare industry	110	110			
Other	15	15			
Total available-for-sale equity securities	$ 275	$ 275			
Total available-for-sale securities	$ 687	$ 369	$ 108	$ 210	
Hedge fund investments					
Equity long/short	$ 55		$ 55		
Global opportunities	35		35		
High-yield debt securities	90			$ 90	
Total hedge fund investments	$ 180		$ 90	$ 90	
Other investments					
Private equity fund investments [b]	$ 25			$ 25	
Direct venture capital: healthcare [a]	53			53	
Direct venture capital: energy [a]	32			32	
Total other investments	110			110	
Derivatives					
Interest rate contracts	57		$ 57		
Foreign exchange contracts	43		43		
Credit contracts	38			38	
Commodity futures contracts	78	$ 78			
Commodity forward contracts	20		20		
Total derivatives	$ 236	$ 78	$ 120	$ 38	
Total recurring fair value measurements	$ 1,366	$ 577	$ 341	$ 448	
Nonrecurring fair value measurements					
Long-lived assets held and used [c]	$ 75		$ 75		$ (25)
Goodwill [d]	30			$ 30	(35)
Long-lived assets held for sale [e]	26		26		(15)
Total nonrecurring fair value measurements	$ 131		$ 101	$ 30	$ (75)

(a) On the basis of its analysis of the nature, characteristics, and risks of the securities, the reporting entity has determined that presenting them by industry is appropriate.

(b) On the basis of its analysis of the nature, characteristics, and risks of the investments, the reporting entity has determined that presenting them as a single class is appropriate.

(c) In accordance with Subtopic 360-10, long-lived assets held and used with a carrying amount of $100 million were written down to their fair value of $75 million, resulting in an impairment charge of $25 million, which was included in earnings for the period.

(d) In accordance with Subtopic 350-20, goodwill with a carrying amount of $65 million was written down to its implied fair value of $30 million, resulting in an impairment charge of $35 million, which was included in earnings for the period.

(e) In accordance with Subtopic 360-10, long-lived assets held for sale with a carrying amount of $35 million were written down to their fair value of $26 million, less costs to sell of $6 million (or $20 million), resulting in a loss of $15 million, which was included in earnings for the period.

(Note: For liabilities, a similar table should be presented.)

Table B

Quantitative Information about Level 3 Fair Value Measurements

($ in millions)

	Fair Value at 12/31/X9	Valuation Technique(s)	Unobservable Input	Range (Weighted Average)
Residential mortgage-backed securities	125	Discounted cash flow	Constant prepayment rate	3.5% – 5.5% (4.5%)
			Probability of default	5% – 50% (10%)
			Loss severity	40% – 100% (60%)
Commercial mortgage-backed securities	50	Discounted cash flow	Constant prepayment rate	3.0% – 5.0% (4.1%)
			Probability of default	2% – 25% (5%)
			Loss severity	10% – 50% (20%)
Collateralized debt obligations	35	Consensus pricing	Offered quotes	20 – 45
			Comparability adjustments (%)	-10% – +15% (+5%)
Direct venture capital investments: healthcare	53	Discounted cash flow	Weighted average cost of capital	7% – 16% (12.1%)
			Long-term revenue growth rate	2% – 5% (4.2%)
			Long-term pretax operating margin	3% – 20% (10.3%)
			Discount for lack of marketability [a]	5% – 20% (17%)
			Control premium [a]	10% – 30% (20%)
		Market comparable companies	EBITDA multiple [b]	10 – 13 (11.3)
			Revenue multiple [b]	1.5 – 2.0 (1.7)
			Discount for lack of marketability [a]	5% – 20% (17%)
			Control premium [a]	10% – 30% (20%)
Direct venture capital investments: energy	32	Discounted cash flow	Weighted average cost of capital	8% – 12% (11.1%)
			Long-term revenue growth rate	3% – 5.5% (4.2%)
			Long-term pretax operating margin	7.5% – 13% (9.2%)
			Discount for lack of marketability [a]	5% – 20% (10%)
			Control premium [a]	10% – 20% (12%)
		Market comparable companies	EBITDA multiple [b]	6.5 – 12 (9.5)
			Revenue multiple [b]	1.0 – 3.0 (2.0)
			Discount for lack of marketability [a]	5% – 20% (10%)
			Control premium [a]	10% – 20% (12%)
Credit contracts	38	Option model	Annualized volatility of credit [c]	10% – 20%
			Counterparty credit risk [d]	0.5% – 3.5%
			Own credit risk [d]	0.3% – 2.0%

(a) Represents amounts used when the reporting entity has determined that market participants would take into account these premiums and discounts when pricing the investments.

(b) Represents amounts used when the reporting entity has determined that market participants would use such multiples when pricing the investments.

(c) Represents the range of the volatility curves used in the valuation analysis that the reporting entity has determined market participants would use when pricing the contracts.

(d) Represents the range of the credit default swap spread curves used in the valuation analysis that the reporting entity has determined market participants would use when pricing the contracts.

(Note: For liabilities, a similar table should be presented.)

Table C

($ in millions)	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)								
	Available-for-Sale Debt Securities			Hedge Fund Investments	Other Investments			Derivatives	
	Residential Mortgage-Backed Securities	Commercial Mortgage-Backed Securities	Collateralized Debt Obligations	High-Yield Debt Securities	Private Equity Fund	Direct Venture Capital: Healthcare	Direct Venture Capital: Energy	Credit Contracts	Total
Opening balance	$ 105	$ 39	$ 25	$ 145	$ 20	$ 49	$ 28	$ 30	$ 441
Transfers into Level 3	60 [a] [b]								60
Transfers out of Level 3	(5) [b] [c]								(5)
Total gains or losses for the period									
Included in earnings (or changes in net assets)	(8)			7	5	3	1	5	13
Included in other comprehensive income	(15)	(5)	(7)					(5)	(32)
Purchases, issues, sales, and settlements									
Purchases		16	17			5	3	18	59
Issues									
Sales	(12)			(62)		(4)			(78)
Settlements								(10)	(10)
Closing balance	$ 125	$ 50	$ 35	$ 90	$ 25	$ 53	$ 32	$ 38	$ 448
Change in unrealized gains or losses for the period included in earnings (or changes in net assets) for assets held at the end of the reporting period				$ (5)	$ 5	$ 3	$ 1	$ 2	$ 6

(a) Transferred from Level 2 to Level 3 because of a lack of observable market data, resulting from a decrease in market activity for the securities.

(b) The reporting entity's policy is to recognize transfers into and transfers out of Level 3 as of the date of the event or change in circumstances that caused the transfer.

(c) Transferred from Level 3 to Level 2 because observable market data became available for the securities.

(Note: For liabilities, a similar table should be presented.)

Table D

	Fair Value (in millions)	Unfunded Commitments	Redemption Frequency (If Currrently Eligible)	Redemption Notice Period
Equity long/short hedge funds [a]	$ 55		quarterly	30–60 days
Event driven hedge funds [b]	45		quarterly, annually	30–60 days
Global opportunities hedge funds [c]	35		quarterly	30–45 days
Multi-strategy hedge funds [d]	40		quarterly	30–60 days
Real estate funds [e]	47	$ 20		
Private equity funds—international [f]	43	15		
Total	$ 265	$ 35		

Appendix
LIFE SETTLEMENT CONTRACTS
Background

Traditional government-purchased insurance is either designed to indemnify a government for loss or is part of employee benefits. Current GAAP for such insurance requires use of the cash surrender value (Statement No. 62, ***Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements, paragraph 31***). This paper does not address traditional insurance and does not propose any changes to existing GAAP. Our research indicates, however, that life insurance policies also may be acquired for income or profit. There are two approaches to acquiring such an investment. First, an investor may acquire life insurance policies from those parties who are insured for the purposes of income or profit. Second, life insurance may begin as part of an employee benefit program. Upon an employee's separation of service from the employer, though, such life insurance converts to an investment vehicle with insurance benefits being paid to the employer or to an employer's pension plan.

Life Insurance Acquired From Policy Holders

An SEC staff report provides an overview of the life insurance/life settlement market. In the fall of 2009, the SEC established a Life Settlements task force to study life settlements and advise the Commission on how to proceed with establishing regulation for this industry. The research of the task force established that a life settlement is a transaction in which an insurance policy owner sells a life insurance policy to a third party for an amount that exceeds the policy's cash surrender value, but is less than the expected death benefit of the policy. A life settlement transaction may be structured in any number of ways, but the following are most common:

1. As an assignment, transfer, sale, devise or bequest of the benefit in a life insurance policy for value
2. As a loan or other lending transaction, secured by one or more life insurance policies
3. As a premium finance loan made for a life insurance policy on or before the date of issuance of the life insurance policy
4. As the transfer for compensation or value of the "interest in a trust or other entity that owns a life insurance policy if the trust or other entity was formed or availed of for the principal purpose of acquiring one or more life insurance contracts."[1]

Policy owners have choices. Once insured, policy owners can sell their policies in the secondary market instead of allowing them to lapse. Policy owners can also surrender these policies to insurance companies in exchange for their cash value.

Life Settlements When the Insureds Are Former Employees

The project staff's research indicates that one structure which certain governments, including pension plans, have considered is life insurance entered into on behalf of employees who also

[1] Life Settlements Model Act § 2(L) (National Conference of Insurance Legislators 2007) ("NCOIL model act").

participate in the government-employer's pension plan. While employed, the insurance benefits extend to the employees and their beneficiaries. Upon the covered employee's separation from the employer, however, the pension plan becomes the beneficiary.

CURRENT GASB GUIDANCE

Investments in life insurance policies by pension plans are addressed in Statement No. 67, *Financial Reporting for Pension Plans*. ("Life settlement contracts" are not addressed.) According to Statement 67, investment assets held as part of a pension plan are measured at fair value. Investments in life insurance, however, should be reported at cash surrender value (paragraph 18). For non-pension plan governments, investments in life insurance policies are addressed in the Comprehensive Implementation Guide. In that guidance a government that makes investments in life insurance policies should measure those policies at their cash surrender values. A government should recognize only the cash proceeds it receives from a death benefit as income after an insured employee has passed away. The notion of pre-recording *expected* death benefit income is thus precluded.

> Q—A government employer purchases life insurance covering the lives of employees and former employees with vested benefits for which the government is the beneficiary. At what amount should the government recognize its investment in life insurance for financial reporting purposes? (Q&A2010S-6.27.1)
>
> A—The government employer should recognize as an investment asset the amount that could be realized by that employer under the insurance contract—cash surrender value—as of the date of the statement of net assets. The government employer should recognize death benefits as income only upon the actual death of an insured; income from death benefits should not be recognized on an actuarially expected or projected basis. [6.27.1]

FASB GUIDANCE SEPARATES INSURANCE FROM INVESTMENT

The current FASB literature continues to provide that a life insurance policy entered into for the purpose of indemnification should be measured at cash surrender value (ASC 325-30-35-1). On the other hand, when entered into as an investment, such a policy is classified as a life settlement contract. The difference between the two classifications is that in a life settlement contract the payer of the insurance premium does not have an insurable interest. Life settlement contracts are specifically defined as having the following characteristics:

a. The investor does not have an insurable interest (an interest in the survival of the insured, which is required to support the issuance of an insurance policy).
b. The investor provides consideration to the policy owner of an amount in excess of the current cash surrender value of the life insurance policy.
c. The contract pays the face value of the life insurance policy to an investor when the insured dies. [FASB Staff Position no. FTB 85-4-1, posted March 27, 2006; ASC 825-30-20]

FASB Accounting for Life Settlements

Under the existing FASB guidance, an investor may account for its investment in life settlement contracts by using either the investment method or the fair value method. While reporting entities are given the option as to how to report life settlement contracts, the guidance further provides that this irrevocable election should be made on an instrument-by-instrument basis and must be adequately documented (ASC 325-30-45). The investment method and the fair value method are discussed in more detail later in this paper but a brief description of each is provided below.

Investment Method

Under the investment method, the initial measurement is the amount of the transaction price plus all initial direct external costs. As time passes, the investor capitalizes continuing costs such as policy premiums and direct external costs needed to keep the policy in force. No gain is recognized until the insured party dies. Upon the death of the insured, the investor records a gain equal to the difference between the carrying amount of the contract and the life insurance proceeds of the underlying life insurance policy (ASC 325-30-35-8 through 11).

Fair Value Method

According to the fair value method, an investor recognizes the initial investment at the transaction price. Then, the investor remeasures the investment in its entirety (the net of future benefit payments less future premiums) at fair value in future periods. Any changes in fair value from period to period are recorded in the period they occur. The investor accounts for any premiums paid or life insurance proceeds received as part of the same line item where the changes in fair value are reported (ASC 325-30-35-12).