University of California

Governmental Accounting Standards Board (GASB) Statement No. 72,

Fair Value Measurement and Application

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Issues Resolution Memo No. 72-1

Evaluation of GASB Statement No. 72 as it relates to UC Reporting Entities

BACKGROUND

GASB issued Statement No. 72 (GASB 72), *Fair Value Measurement and Application,* was adopted by the University beginning July 1, 2015. This statement addresses accounting and financial reporting issues related to fair value measurements. The definition of 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. This Statement provides guidance for determining a fair value measurement for financial reporting purposes. This Statement also provides guidance for applying fair value to certain investments and disclosures related to all fair value measurements.

DEFINE ISSUES

The University must determine whether GASB Statement No. 72 changes any existing financial reporting and disclosure requirements for any of the University's financial reporting entities.

AUTHORITATIVE GUIDANCE AND APPROACH

GASB Statement 72, paragraphs 5-17 address the general principles of Fair value measurement. Fair value is described as an exit price. Fair value measurements assume a transaction takes place in a government's principal market, or a government's most advantageous market in the absence of a principal market. The fair value also should be measured assuming that general market participants would act in their economic best interest. Fair value should not be adjusted for transaction costs.

To determine a fair value measurement, a government should consider the unit of account of the asset or liability. The unit of account refers to the level at which an asset or a liability is aggregated or disaggregated for measurement, recognition, or disclosure purposes as provided by the accounting standards. For example, the unit of account for investments held in a brokerage account is each individual security, whereas the unit of account for an investment in a mutual fund is each share in the mutual fund held by a government.

GASB Statement 72, paragraphs 18-54 describe valuation techniques that are appropriate under the circumstances and for which sufficient data are available to measure fair value. The techniques should be consistent with one or more of the following approaches: the market approach, the cost approach, or the income approach. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets, liabilities, or a group of assets and liabilities. The cost approach reflects the amount that would be required to replace the present service capacity of an asset. The income approach converts future amounts (such as cash flows or income and expenses) to a single current (discounted) amount. Valuation techniques should be applied consistently, though a change may be appropriate in certain circumstances. Valuation techniques maximize the use of relevant observable inputs and minimize the use of unobservable inputs.

GASB Statement 72, paragraphs 32-44, establishes a hierarchy of inputs to valuation techniques used to measure fair value. That hierarchy has three levels:

- Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities.
- Level 2 inputs are inputs—other than quoted prices—included within Level 1 that are observable for the asset or liability, either directly or indirectly.
- Level 3 inputs are unobservable inputs, such as management's assumption of the default rate among underlying mortgages of a mortgage-backed security.

GASB Statement 72, paragraphs 45-54, discuss additional fair value analysis required if the volume or level of activity for an asset or liability has significantly decreased. It also requires identification of transactions that are not orderly. Quoted prices provided by third parties are permitted, as long as a government determines that those quoted prices are developed in accordance with the provisions of this Statement.

GASB Statement 72, paragraphs 55-79, discuss measurement principles and application of certain assets/liabilities. A fair value measurement takes into account the highest and best use for a nonfinancial asset. A fair value measurement of a liability assumes that the liability would be transferred to a market participant and not settled with the counterparty. In the absence of a quoted price for the transfer of an identical or similar liability and if another party holds an identical item as an asset, a government should be able to use the fair value of that asset to measure the fair value of the liability. A government is permitted to establish the fair value of an investment in a nongovernmental entity that does not have a readily determinable fair value by the Net Asset Value (NAV) per share (or its equivalent). Per paragraph 76 of Appendix B, the board acknowledged the significance of split-interest agreements but concluded that addressing the accounting and financial reporting for such transactions should not be within the scope of this project.

GASB Statement 72, paragraph 64 states: "Except as provided in paragraph 69, investments should be measured at fair value. An investment is a security or other asset that (a) a government holds primarily for the purpose of income or profit and (b) has a present service capacity based solely on its ability to generate cash or to be sold to generate cash." Therefore, the University and its reporting entities have to evaluate whether it has investments that would meet these requirements such as real estate held for investments that were previously reported at cost that would need to be measured and reported at fair value.

GASB Statement 72, paragraphs 80-82, discuss disclosure requirements. For recurring and nonrecurring fair value measurements, disclosures should include the fair value measurement at the end of the reporting period, categorized by the level of the fair value hierarchy used to determine the fair value. Disclosures should also include a description of the valuation technique used in the fair value measurement as well as a discussion of any changes in valuation technique that would have a significant impact on the results. Additional disclosures for fair value measurements of investments in certain entities that calculated the net asset value per share (or its equivalent) are required per paragraph 82.

IMPLEMENTATION

The requirements of GASB Statement No. 72 are meant to enhance comparability of financial statements among governments by requiring measurement of certain assets and liabilities at fair value using a consistent and more detailed definition of fair value and accepted valuation techniques. This Statement is also intended to enhance fair value application guidance and related disclosures in order to provide information to financial statement users about the impact of fair value measurements on a government's financial position.

In evaluating GASB Statement No. 72 as it relates the UC Reporting Entities, the impact of the statement will primarily be related to the financial statement disclosures. Specifically, the disclosure of investments and other assets reported at fair value within the fair value hierarchy. Additionally, as discussed below in the Additional Considerations section, GASB 72 will result in additional considerations related to internal controls and the evaluation of an asset as an investment vs. capital asset.

In accordance with GASB Statement No. 72, the Universities assets and liabilities will be reported at fair value and organized into a hierarchy based on the levels of inputs observable in the marketplace that are used to measure fair value. Inputs are used in applying the various valuation techniques and take into account the assumptions that market participants use to make valuation decisions. Inputs may include price information, credit data, liquidity statistics, and other factors specific to the financial instrument. Observable inputs reflect market data obtained from independent sources. In contrast, unobservable inputs reflect the entity's assumptions about how market participants would value the financial instrument.

A financial instrument's level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. The following describes the hierarchy of inputs that will be used to measure fair value and the primary valuation methodologies used for financial instruments measured at fair value on a recurring basis:

Level 1 – Prices based on unadjusted quoted prices in active markets that are accessible for identical assets or liabilities are classified as Level 1. Level 1 investments include equity securities commingled funds (exchange traded funds and mutual funds), certain exchange traded derivatives (warrants, rights, options, futures) and other publicly traded securities.

Level 2 – Quoted prices in the markets that are not considered to be active, dealer quotations, or alternative pricing sources for similar assets or liabilities for which all significant inputs are observable, either directly or indirectly are classified as Level 2. Level 2 investments include fixed- or variable-income securities, commingled funds (institutional funds not listed in active markets), certain non-exchange traded derivatives (warrants, rights, options, futures, repurchase agreements, swaptions, and swaps), and other assets that are valued using market information.

Level 3 – Investments classified as Level 3 have significant unobservable inputs, as they trade infrequently or not at all. The inputs into the determination of fair value of these investments are based upon the best information in the circumstance and may require significant management judgment. Level 3 investments include private equity investments, real estate and split interest agreements. Interests in certain direct investments in real estate are estimated based upon independent appraisals. Because the private equity, real estate and absolute return partnerships, along with direct investments in real estate, are not readily marketable, their estimated value is subject to uncertainty and, therefore, may differ significantly from the value that would be used had a ready market for such investments existed. These investments are generally less liquid than other investments, and the value reported may differ from the values that would have been reported had a ready market for these investments existed.

Net Asset Value (NAV) – Investments whose fair value is measured at NAV are excluded from the fair value hierarchy. Investments in non-governmental entities that do not have a readily determinable fair value may be valued at NAV. Investments measured at NAV included hedge funds, private equity investments, and commingled funds. Private equities include venture capital partnerships, buyout and international funds. Fair values for interests in private equity, absolute return partnerships and real estate partnerships are based on valuations provided by the general partners of the respective partnerships. The valuations are primarily based on the Net Asset Value (NAV) of the underlying investments. The net asset value (NAV) is reported by the external investment managers, including general partners, in accordance with their policies as described in their respective financial statements and offering memoranda. The most recent NAV is adjusted for capital calls, distributions and significant known valuation changes, if any, of its related portfolio through fiscal year end. The University exercises due diligence in assessing the external managers' use of and adherence to fair value principles. In conjunction with these procedures, estimated fair value is determined by consideration of a wide range of factors, including market conditions, redemption terms and restrictions and risks inherent in the inputs of the external investment managers' valuation. In situations where the information provided by the external manager is deemed to not be representative of the fair value as of the measurement date, management evaluates specific features of the investment and utilizes supplemental fair value information provided by the external manager along with any relevant market data to measure the investment's fair value.

Not Leveled - Generally, cash equivalents are measured at other than fair value (including amortized cost) and, thus, are not subject to the fair value disclosure requirements. Investments excluded from the fair value hierarchy include US dollars held as part of funds owned solely by The University. If an investment is measured at fair value, it is included in the fair value hierarchy.

The following format will be used to summarize the investments and other assets reported at fair value within the fair value hierarchy as of year-end for the University, Medical Centers and Retirement System:

(in thousands of dollars)	UNIVERSITY OF CALIFORNIA					
	Total	Quoted Prices in Active Markets	Other Observable Inputs	Unobservable Inputs	Net Asset Value	Not Leveled
		(Level 1)	(Level 2)	(Level 3)	(NAV)	
Equity securities						
Fixed or variable income securities:						
U.S. government guaranteed						
Other U.S. dollar denominated						
Foreign currency denominated						
Commingled funds						
Investment derivatives						
Mortgage loans						
Real estate						
Externally held irrevocable trusts						
Other investments						
Campus foundations' investments with the University						
UCRS investment in STIP						
Total investments						
Securities lending investments of cash collateral						
Investments held by trustees						

For additional considerations related to the Fair Value hierarchy classifications, please refer to the table at the end of this memo.

The University will address the nature and risk of the investments and whether the investments are probable of being sold at amounts different from the NAV per share (or its equivalent) using the format provided below.

(in thousands of dollars)	UNIVERSITY OF CALIFORNIA		
Investment Type	Fair value	Unfunded Commitments	Redemption terms and restrictions
Absolute return and hedge funds			
Private equities			
Real assets			
Real estate			

Note that for UCRS reporting and reporting for the University's discretely presented component units (i.e. Campus Foundations), disclosures will be made separately for UCRSP, UCRP, PERS PLUS 5 and the discretely presented component units.

ADDITIONAL CONSIDERATIONS

1. Internal controls considerations

For instances in which the University relies on fair value measurements from a custodian, the University must exercise due diligence in assessing the external managers' use of and adherence to fair value principles. In conjunction with these procedures, estimated fair value is determined by consideration of a wide range of factors, including market conditions, redemption terms and restrictions and risks inherent in the inputs of the external investment managers' valuation. In situations where the information provided by the external manager is deemed to not be representative of the fair value as of the measurement date, management evaluates specific features of the investment and utilizes supplemental fair value information provided by the external manager along with any relevant market data to measure the investment's fair value.

As part of the assessment described in the preceding paragraph, validation of the leveling information provided by the custodian will be done through attribute sampling. Please refer to the FAQ's documented at the end of this memo for additional detail.

2. Investments vs. Capital Assets

In accordance with GASB 72, paragraphs 64 to 68, before applying the fair value measurement guidance, the University should determine whether an asset should be classified as an Investment or a Capital Asset. Note that the University (and its reporting entities) should maintain the classification made at the acquisition of the asset throughout its life. The list below includes factors to be considered in evaluating if an asset should be classified as an investment or capital asset. While the final decision is a matter of judgment, meeting more than some of the criterion below as a capital asset would likely result in capital asset treatment.

Considerations	Discussion
Where is the property located?	A property on, near or close to a campus or medical center may be an indicator that the property should be considered a capital asset instead of an investment. Investments are recorded at fair value and may appreciate over time, capital assets are depreciated based on use.
What is the present service capacity of the property?	Consideration should be given to whether the property is connected to the University's mission of teaching, research, clinical care or public service. Properties such as apartments for student housing, facilities with classroom space or physician office buildings are examples, but not a complete list, of properties that may be considered capital assets instead of investments.
Who are the tenants? How does the University's current or future use of the property affect the economic evaluation of the acquisition?	If the University's use of the property can be excluded or is clearly minimal, the property could be considered an investment; if use by the University is significant or required to meet economic targets, the property should be considered a capital asset.
Does the property fit the profile of properties that would be considered for acquisition?	If the property does not fit the normal profile, is the property being considered because of the location, service capacity or economics of the University's use of the property? The overall size of the property or the characteristics of the property, such as retail space without anchor tenants may not meet the investment criteria used as guidelines for considering acquisitions, and may be an indicator that the property is a capital asset.
Are there plans to renovate the property to accommodate use by the University?	If there are plans to accommodate use of property by the University, the property should be reported as a capital asset instead of an investment.
Are there any conditions that would indicate the property is being acquired for operations instead of income or profit?	Operating conditions such as requirements that UC students be given priority when renting apartments, limitations on rent increases involvement or approvals by campus teams in operating decisions would indicate the property is a capital asset.

Additionally, even if an asset is classified as an investment, operating the property as a capital asset could call into question whether the initial determination of the asset is defensible and appropriate. After acquisition, certain factors could present medium or high risk that the original classification should have been capital assets instead of investment. See GASB 72 checklist for use in performing the investments vs. capital assets analysis as outlined in this section.

Please refer to FAQ's at the end of this memo for additional information.

CONCLUSION

Implementation of GASB Statement No. 72 will impact the financial statement disclosures of the University as outlined above. The University will continue to assess future impacts to the financial statements.

FREQUENTLY ASKED QUESTIONS:

How should investments in the pools managed by the Office of the Chief Investment Officer of the Regents (OCIO) be classified? How should direct investments managed by OCIO be classified?

For Campuses, Campus Foundations and 3rd parties who invest in the pools managed by the OCIO (i.e., General Endowment Pool (GEP), Short-Term Investment Pool (STIP), and Total Return Investment Pool (TRIP)), these investments are considered to be external investment pools. These should be reported at net asset value and excluded from the fair value level hierarchy.

For Campus Foundations and 3rd parties that hold direct investments managed by the OCIO (outside of GEP, STIP and TRIP), UCOP's Endowment & Investment Accounting unit will provide the levelling information that would be consistent with the levelling information used for the University's financial statements.

Do we need to disclose a roll forward of the level, similar to what's done by FASB reporters?

No. GASB 72 does not require this information.

What should I do if the leveling information returned by State Street (custodian) is blank?

If leveling information returned by State Street (custodian) is blank, consider the following steps to determine the appropriate fair value level:

1) Obtain the security CUSIP (investment managers and custodians sometimes use dummy CUSIPs or asset IDs to track securities so ensure that you obtain the security CUSIP)
2) Determine the type of security and the pricing source(s) used to determine the price of the security.

What should I do if we have reclassifications made after the leveling information was provided?

When reclassifications are made between types of investments, ensure that the reclassification is appropriately reducing the level that you are reclassifying from and increasing the level that you are increasing. Examples of areas of reclassification will include fund of funds where all investments in the parent and child fund are held by you and derivatives that are not classified under derivatives and need to be reclassified to the derivatives investment line item.

What do I need to do to validate the leveling information provided by State Street?

Validation of the leveling information provided by State Street will be done through attribute sampling. Since State Street only provides leveling information for level 1 and level 2 investment holdings, there is minimal judgement used in determining the fair value level. Further, the risk of material misstatement is determined to be low for the fair value hierarchy disclosures. As such, it is determined that a confidence level of 95%, an expected deviation rate of 0.00%, and a tolerable deviation rate of 10% provides sufficient comfort over the fair value leveling performed by State Street on level 1 and level 2 investment holdings, resulting in a sample size of 30.

Do I need to ask for additional information from State Street or others?

When beginning the process of obtaining the information from an investment manager or custodian, you can begin by asking the investment manager or custodian for their pricing level policy and/or any communication they may have on GASB Statement 72.

What information do I need in order to complete the disclosure requirements of paragraph 82?

Additional disclosures for fair value measurements of investments in certain entities that calculate the net asset value (NAV) per share (or its equivalent) are outlined in paragraph 82. A government should disclose information that addresses the nature and risks of the investments and whether the investments are probable of being sold at amounts different from the NAV per share or its equivalent. Such information would include the following:

1) Amount of unfunded commitments related to that investment type
2) General description of the terms and conditions upon which a government may redeem investments in the type (for example, quarterly redemption with 60 days' notice)
3) Circumstances in which an otherwise redeemable investment might not be redeemable (for example, investment subject to a redemption restriction such as a lockup or gate)
4) Any other significant restriction on the ability to sell investments in the type at the measurement date

For entities who invest in GEP, the terms and conditions upon which GEP may be redeemed are monthly with 30 days notice. The restriction below is identified, but waivers from the President can be obtained as long as there is sufficient liquidity in the pool.

The "Administrative Guidelines for Allocation, Reallocation and Administration of Gifts and Bequests Received by The Regents and the Campus Foundations" were adopted in 2006. The focus is on the types of funds that are established, but they also provide some guidance on what distributions are possible (since there should be an understanding at the front end of the consequences of any allocation decision).

The particular provision includes the following:

> **"A withdrawal from the corpus of a Regents' FFE may be made only during the fourth quarter of the fiscal year. The President must approve any allocation or reallocation proposal that would withdraw more than five percent from the corpus of an FFE having a market value of more than $5,000,000."**

The guidelines can be found at the following: http://policy.ucop.edu/doc/6000435/Gifts-Regents

When an investment's NAV is rolled forward from a date prior to the measurement date by the Foundation, is this fair value price still considered at NAV?

If an investment's NAV is provided to UC/foundation prior to the measurement date (e.g. 3/31/16 NAV provided for 6/30/16 year end) and the UC/foundation performs a roll forward of the NAV to the measurement date (e.g. 6/30/16) the investment is considered to be measured at NAV and is excluded from the fair value hierarchy.

When an investment's NAV is provided at a date prior to the measurement date and the investee provides an estimated updated NAV to the Foundation at the measurement date is this still considered at NAV?

If an investment's NAV is provided to UC/foundation prior to the measurement date (e.g. 3/31/16 NAV provided for 6/30/16 year end) and an updated estimated NAV is provided for the measurement date (e.g. 6/30/16) the investment is considered to be measured at NAV and is excluded from the fair value hierarchy. UC/foundation still needs to ensure that the NAV is being calculated in accordance with fair value measurement.

What other types of assets and liabilities are within scope of GASB 72?

Generally, any asset or liability measured at fair value is within scope of GASB 72. As an example, this includes derivatives held, and investment of cash collateral received as part of securities lending activity.

Are cash equivalents subject to the fair value disclosure requirements of Statement 72?

Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. Generally, cash equivalents are measured at other than fair value (including amortized cost) and, consequently, are not subject to the fair value disclosure requirements of Statement 72. Specific exceptions to fair value measurement for some investments are described in paragraph 69 of Statement 72. Examples of such investments include certain money market investments and nonparticipating interest-earning investment contracts, such as certain nonnegotiable certificates of deposit (CDs). If a cash equivalent is measured at fair value, the fair value disclosure requirements of Statement 72 apply.

Additional Considerations for Fair Value Hierarchy Classification

University of California					
GASB 72 Implementation					
Fair Value Hierarchy Classification Considerations					
	Level 1	**Level 2**	**Level 3**	**Net Asset Value**	**Not subject to fair value level hierarchy**
Equity securities:					
Domestic	X - traded on active exchange	X - preferred stock (if adjusted and not actively traded in an exchange)	X - not publicly traded or securities that have associated credit or liquidity risk issues		
Foreign	X - traded on active exchange		X - not publicly traded or securities that have associated credit or liquidity risk issues		
Equity securities					
Fixed or variable income securities:					
U.S. government guaranteed:					
U.S. Treasury bills, notes and bonds		X			
U.S. Treasury strips		X			
U.S. TIPS		X			
U.S. government-backed securities		X			
U.S. government-backed - asset-backed securities		X - except for thinly traded	X - thinly traded		
U.S. government guaranteed					
Other U.S. dollar denominated:					
Corporate bonds		X - except for thinly traded and Reg. 144 (or equivalent) securities that are not broadly traded / has limited distribution to knowledgeable investors	X - thinly traded		
Commercial paper		X			
U.S. agencies		X			
U.S. agencies - asset-backed securities		X - except for thinly traded	X - thinly traded		
Corporate - asset-backed securities		X	X - non-securitized transactions or securitized transactions with unobservable inputs		
Supranational/foreign		X - except for thinly traded	X - thinly traded		
Other		X - except for thinly traded	X - thinly traded		
Other U.S. dollar denominated					
Foreign currency denominated:					
Government/sovereign		X	X - for currencies that aren't observable with highly inflationary economies or associated credit or liquidity risk issues (e.g., Greece in 2015 and Egypt in 2012)		
Corporate		X			
Foreign currency denominated					
Commingled funds:	X - mutual funds traded on active exchange		X - if NAV available, but not used because we did NOT rely on NAV	X	
Absolute return funds			X - if NAV available, but not used because we did NOT rely on NAV	X	
Non-U.S. equity funds				X	
Private equity			X - if NAV available, but not used because we did NOT rely on NAV	X	
Money market funds	X - traded on active exchange			X	
U.S. equity funds	X - traded on active exchange			X	
Real estate investment trusts				X	
Real assets			X - if NAV available, but not used because we did NOT rely on NAV	X	
U.S. bond funds				X	
Non - U.S. bond funds				X	
Balanced funds				X	
Commingled funds					
Investment derivatives					
Futures contracts	X				
Futures currency exchange contracts		X			
Swaps		X			
Stock rights / warrants	X				
Options / swaptions	X - options	X - swaptions			
Publicly traded real estate investment trusts	X		X - if thinly traded		
Mortgage loans			X		
Insurance contracts		X			
Real estate			X - direct investment	X	
Deposit agreement					
Other investments			X		
Foreign cash held in internal funds		X	X - for currencies that aren't observable with highly inflationary economies or associated credit or liquidity risk issues (e.g., Egypt in 2012)		
USD Cash held in internal funds					X
Campus foundations' investments with the University				X	