INVESTMENT ACCOUNTING AND GASB 72
Agenda

GASB 31

Methods of Accounting for Investments

Investment Fraud

Best Practice Internal Controls

GASB 40 Disclosures

GASB 72 Disclosures
GASB 31: Accounting and Financial Reporting for Certain Investments and for External Investment Pools
Public entities should report investments at **fair value** on the balance sheet

The change in fair value from year to year should be recognized in the operating statement

Certain investments are not reported at fair value

- Investment Agreements
- Money Market Mutual Funds
- Certain External Investment Pools
Investment in Local Government Pool

- Investments in pools (LAIF, CAMP, County Pool) must also be reported at fair value

- For LAIF, this information can be obtained at:
  http://www.treasurer.ca.gov/pmia-laif/reports/valuation.asp
Fair value: $69,480,310,142

Divided by Cost: $69,459,025,448

= 1.000306435

If you had $10,000,000 invested in LAIF, the fair value at 2/28/17 would be $10,000,000 x 1.000306435

= $10,003,064

June 30, 20XX statement will have the amortization calculation at the bottom of the schedule.
Bid Price or Asked Price

GASB *CIG 6.11.7. Q—A bid price represents the price a willing buyer will pay; an asked price represents the price the seller would like to receive. If actual sales prices are not available when determining fair value, should bid or asked prices be used?

A—Statement 31 does not take a position on this issue. Practice generally is to use bid prices, because they are the amounts at which transactions presumably will be completed.

* The acronym CIG represents refers to the Comprehensive Implementation Guide published by GASB
GASB CIG 6.28.1. Q—Should investment transactions be accounted for based on the trade date (the date the order to buy or sell the investment is placed) or the settlement date (the date that the cash and investment instrument are exchanged)?

A—Investment transactions should be accounted for based on the **trade date**. The trade date is the date on which the transaction occurred and is the date the government is exposed to (or released from) the rights and obligations of the ownership of the instrument.

*Note – This becomes important for transactions that occur close to year end*
Methods of Accounting for Investments
Option 1: Cash Basis

- Accounting is recorded when transaction is completed (receipt of interest, proceeds from sale, etc.)
- At fiscal year end, adjust cost to fair value (if material)
- Benefit – simplicity
- Weakness – no recognition during the year of fair value changes
Option 1: Cash Basis

- Commercial Paper, $1,000,000 par bought 5/16 for $998,576; matures 12/17
- Amortized cost at 5/31 is $998,751
- Fair value at 5/31 is $998,620

<table>
<thead>
<tr>
<th>Cash</th>
<th>Investments</th>
</tr>
</thead>
<tbody>
<tr>
<td>998,576</td>
<td>998,576</td>
</tr>
</tbody>
</table>
Option 2: Amortization Method

- Amortizes premiums and discounts over the life of the investment
- At fiscal year end, adjust cost to fair value (if material)
- Benefit – consistent recognition of revenue
- Weakness – no recognition during the year of fair value changes although amortization method may approximate fair value changes
Option 2: Amortization Method

<table>
<thead>
<tr>
<th>Cash</th>
<th>Investments</th>
</tr>
</thead>
<tbody>
<tr>
<td>998,576</td>
<td>998,576</td>
</tr>
<tr>
<td></td>
<td>175</td>
</tr>
<tr>
<td>Investment Income</td>
<td></td>
</tr>
<tr>
<td>175</td>
<td>175</td>
</tr>
</tbody>
</table>
Option 3: Fair Value Method

- Recognizes market fluctuations
- Benefit – no surprises at the end of the year
- Weakness – can be difficult to explain fair value fluctuations each month/quarter
Option 3: Fair Value Method

Cash

| 998,576 |

Investment Income

| 44 |

Investments

| 998,576 |

| 44 |
Comparison of Methods

- Cash basis - No income earned as of May 31, on balance sheet at a value of $998,576
- Amortization method - Income of $175 as of May 31, on balance sheet at a value of $998,751
- Fair value method - Income of $44 as of May 31, on balance sheet at a value of $998,620
Investment Fraud
Fraud Doesn’t Pay

Former Ramapo official admits guilt in municipal bond fraud

Former Placentia finance manager gets 25 years in prison for embezzling more than $5 million

Quarter horse owner gets 19 1/2 years for embezzling in Illinois
Town of Ramapo, New York

- April 2017 – criminal trial marks the first attempt to convict officials for fabricating a municipalities’ financial statements in order to raise money in the bond market
- Hid Town’s involvement in a $58M minor-league stadium project after voters had rejected a resolution to approve bonds to help build the facility
- Recorded $3.67M from the sale of Town land that never was sold
- Hid financial problems by transferring assets from a restricted fund to the General Fund and recording a $3.1M FEMA receivable where no claim had been submitted
$5.16M embezzled by Placentia Finance Services Manager Michael Nguyen

Between 1/27/14 and 4/12/16, Nguyen made 36 wire transfers from a City account to several other accounts personally belonging to him and other recipients

Detected when Las Vegas Casino employees were suspicious when they got a wire transfer from the City of Placentia – they were told it was for a film project – reported concerns to FBI
City of Placentia

- **Pressure:**
  - Parents were going through bankruptcy

- **Rationalization:**
  - Gambling habit

- **Opportunity:**
  - Turnover in the Finance Department led to interim change in responsibilities
  - Manipulated computer software and altered bank statements to conceal fraud
  - Lack of proper oversight
Fraud Hotline for reporting suspected cases of fraud, waste or abuse by employees, contractors or vendors

Department Head, Finance Director, and City Manager must approve a wire transfer by entering encrypted codes

City now prints hard copies of bank statements, which are harder to alter than electronic files
Could this Happen at Your Office?

- Have you increased your use of Wire Transfers, EFTs, and ACHs?
- Does your bank allow you to send a wire transfer, EFT or ACH without a second approval?
- If your bank does require a second approver, who is authorized to add approvers?
- Is your process for repetitive transfers different?
- Are your controls over auxiliary checking or investment accounts different?
If it Happened, Would you Detect It?

- Is the person who reconciles the checking account someone who does not have access to authorize or approve wire transfers?
- Does your bank reconciliation include looking at support and approvals for wire transfers or simply matching up what is reported by the bank to what is recorded in the accounting system?
- Do you still get hard copies of bank statements or are most statements obtained electronically?
Best Practice Internal Controls
Bank Account Fraud Prevention
Best Practice
GFOA recommends that governments consider the following steps to protect themselves against bank account fraud:
Internal Controls
Committee: Treasury and Investment Management
Read more

Cash Flow Analysis
Best Practice
Committee: Treasury and Investment Management
Read more

Collateralizing Public Deposits
Best Practice
GFOA recommends the use of a written agreement with pledging requirements as protection for state or local government’s deposits. GFOA encourages governmental entities to establish adequate and efficient administrative systems to monitor such pledged collateral, including state or locally administered collateral pledging or collateral pools.
Committee: Treasury and Investment Management
Read more

Diversifying the Investment Portfolio
Best Practice
GFOA recommends that state and local governments properly manage the risk in their portfolios to achieve their investment objectives and comply with their investment constraints. GFOA further recommends the use of diversification in a portfolio as an important strategy for managing risk.
Committee: Treasury and Investment Management
Read more
GFOA Best Practices

- Surprise audits
- Physical security of check stock
- Additional review of checks over a certain amount
- Require two party authorization on wires and ACH
- Daily staff reconciliations of wires and ACH
- Proper segregation of duties
- Review of signature cards and authorizations annually
- Eliminate bank accounts not frequently used
Controls over Wire Transfers

- Initiator of the transfer
- Approver of the transfer
- Bank enforcement of this protocol
- Use of tokens to ensure identity of approver (random passwords that change constantly)
- Establishment of templates that prescribe the bank accounts involved in transfers
- Requirement of two persons to change template
- During the bank reconciliation process, the reconciler should verify that the required approval was obtained for each transfer
Cash Reconciliation

- Bank Reconciliation vs. General Ledger Cash Reconciliation
- General Ledger Cash Reconciliation may be the most important accounting control for an entity
- Must encompass 100% of cash and investment accounts and 100% of general ledger accounts
- Should be performed each month (not just for the audit)
- Should be performed in a timely manner (with 30-60 days of month end)
- Must reconcile to $0
How To Do a Cash Reconciliation

- Prepare a listing that totals up each fund’s cash balance as of a given date (e.g., month end) – from the general ledger reports produced by the entity’s accounting system
- Prepare a listing that totals up the balance of each bank account (adjusted for recorded items not yet cleared) and investment balances held as of that date – from the month end bank/custodian statements
- Ensure that the two listings are in agreement (investigate differences)

*Internal control objectives are maximized when the amounts for step 2 are pulled from independent custodian statements (rather than statements from your investment manager)*
GASB 40 Disclosures
Significant Impacts

- To inform the reader about certain risks that are associated with an entity’s portfolio
  - Credit Risk
  - Foreign Currency Risk
  - Interest Rate Risk
    - Specific identification
    - Segmented time distribution
    - Weighted average maturity
    - Simulation model
    - Duration
  - Legal Compliance Risk
Credit Risk

- Disclose ratings as of end of the year (not when you bought it)
- Investments can be grouped by range of ratings and do not require credit quality modifiers (Aa1, Aa2, Aa3)
- US Treasury Securities are exempt from rating
- Disclose which investments are not rated (LAIF for example)
- Also required for investments held by fiscal agents
Credit Risk: Federal Agencies

[GASBIG 2015-1, Q1.5.5]

.738-2 Q—Do the credit quality ratings of all NRSROs need to be disclosed? What if a government invests in a security that receives split ratings? That is, NRSROs issued different ratings on the same security. What credit quality disclosures should be made?

A—There are several recognized NRSROs at this time. Currently, the Securities and Exchange Commission (SEC) reviews the qualifications of applicant credit quality rating firms to determine if they meet the criteria for becoming an NRSRO. This section does not specifically address whether the credit quality ratings of all NRSROs need to be disclosed.

Many securities have ratings from more than one NRSRO, and sometimes those ratings differ. When multiple ratings exist and the government is aware of the different ratings, the rating indicative of the greatest degree of risk should be presented. However, a government may also choose to disclose additional credit quality ratings, thereby presenting the user with additional credit risk information from which to ascertain the credit risk of the investment.
Other Credit Risk Disclosures

- **Concentration of Credit Risk:**
  - Any one issuer that represents 5% or more of the entity’s total portfolio

- **Custodial Credit Risk**
  - Bank accounts over FDIC limit that are not collateralized
  - Investments that are held by the broker or dealer (instead of using an third party custodian)
## Interest Rate Risk

### Segmented Time Distribution Method

<table>
<thead>
<tr>
<th>Investment Type</th>
<th>Fair Value</th>
<th>Less Than 1</th>
<th>1–5</th>
<th>6–10</th>
<th>More Than 10</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Treasuries</td>
<td>$ 28,729</td>
<td>$ 10,865</td>
<td>$ 12,864</td>
<td>$ 5,000</td>
<td>$ —</td>
</tr>
<tr>
<td>U.S. agencies</td>
<td>112,974</td>
<td>89,360</td>
<td>15,000</td>
<td>8,614</td>
<td>—</td>
</tr>
<tr>
<td>Municipal obligations</td>
<td>23,896</td>
<td>23,896</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Corporate bonds</td>
<td>62,061</td>
<td>26,568</td>
<td>10,000</td>
<td>20,493</td>
<td>5,000</td>
</tr>
<tr>
<td>Negotiable certificates of deposit</td>
<td>25,000</td>
<td>25,000</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Commercial paper</td>
<td>39,331</td>
<td>29,589</td>
<td>9,742</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Repurchase agreements</td>
<td>74,509</td>
<td>73,509</td>
<td>1,000</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Investment in money market funds</td>
<td>30,979</td>
<td>30,979</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Investment in State Local Agency</td>
<td>30,000</td>
<td>30,000</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Investment Fund</td>
<td>30,000</td>
<td>30,000</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$ 427,479</strong></td>
<td><strong>$ 339,766</strong></td>
<td><strong>$ 48,606</strong></td>
<td><strong>$ 34,107</strong></td>
<td><strong>$ 5,000</strong></td>
</tr>
</tbody>
</table>
Highly Sensitive Investments

- **Auction rate securities**—securities whose interest rates are set by frequent remarketing
- **Coupon multipliers**—a variable rate instrument where the interest rate is expressed as a *multiple* of an underlying index.
- **Variable rates with floors, caps, and collars**
- **Securities with callable step-up features**
- **Range notes**—interest rates depend on whether or not the benchmark index falls within a pre-determined range.
- **Inverse floaters**—interest rate moves in the opposite direction of the underlying index
- **Mortgage-pass through securities**—cash flows determined by the mortgage payments of an underlying pool of mortgages
Legal Compliance Risk

- Allowable investments (and any limitations) under entity’s investment policy must be disclosed
- Differences between investment policy and requirements of state law should be disclosed
- Violations of investment policy or state law must also be disclosed
- Bond requirements for investment of bond proceeds should be disclosed
GASB 72 Disclosures
Significant Impacts

- Clarifies how fair value should be measured for certain assets and liabilities that are currently required to be reported at fair value
- Generally only applies to certain investments and interest rate swaps
- Sets the stage for GASB to require more assets and liabilities to be reported at “fair value” in the future
What is an Investment?

- **Definition of an investment**
  - 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.
What is an Investment?

4.40. Q—A city government constructs an office building with the intent to occupy the building for a city program. While the city awaits the grant approval, the city leases the building and receives lease income. Should the building initially be classified as an investment and then reclassified when the city uses the building for the city’s program?

A—No. The asset should be classified at acquisition as a capital asset. Because the city intended, at acquisition, to use the building for the purpose of a city program, the building does not meet the definition of an investment. After an asset is classified at acquisition, its classification should not change.

4.41. Q—A city government seeks to provide affordable housing to the community. It lends money to its housing authority (a component unit of the city) to complete the development of an existing affordable-housing project. The housing authority will repay the loan over a 20-year period and will compensate the city with an interest rate commensurate with market conditions. Should the city classify this loan as an investment?

A—No. The loan is a receivable and not an investment because the purpose of the loan is to support its affordable-housing program.

Source: 2016 GASB Implementation Guide
Hierarchy of Fair Value Inputs

- **Level 1** – quoted prices in active markets for identical assets or liabilities

- **Level 2** – quoted prices for similar assets or liabilities
  - quoted prices for identical or similar assets/liabilities in markets that are not active
  - Other than quoted prices that are observable

- **Level 3** – unobservable inputs
  - Inputs when actual market data is not available
  - Assumptions and considerations that market participants use when pricing the asset
Common Categorization

- **Level 1** – US Treasury Securities, Stock
- **Level 2** – Federal Agency Securities, Corporate Notes and Bonds, Municipal Bonds
- **Level 3** – Investment in Real Estate solely for investment earnings
- **COMMON ERROR** – Don’t include these investments in the fair value hierarchy disclosure:
  - Money Market Funds
  - LAIF
  - CAMP
  - County Pool
External Investment Pools

2017 GASB Implementation Guide (Exposure Draft) clarifies how to report External Investment Pools in the schedule of fair value hierarchy

Q. 4.38: If pool is compliant with GASB 79 and elects to measure its investments at amortized cost, the government measures the investment at amortized cost and it should not be categorized within the fair value hierarchy.

If the pool measures investments at fair value, regardless of whether the pool transacts with participants at a floating net asset value per share or a fixed net asset value per share (for example $1.00), positions in external investment pools that are measured at fair value should not be categorized within the fair value hierarchy.
Required Disclosures

- Organize investments by type or class of assets or liabilities
- Information for each class or type of asset/liability
  - Fair value at financial statement date
  - Level of hierarchy
  - Description of valuation techniques
- Additional disclosures for Level 3
  - Changes in value during the year (purchases, sales, change in fair value)
Disclosure Example

The City categorizes its fair value investments within the fair value hierarchy established by generally accepted accounting principles. The City has the following recurring fair value measurements as of June 30, 2016:

<table>
<thead>
<tr>
<th>Fair Value Hierarchy</th>
<th>Level 1</th>
<th>Level 2</th>
<th>Level 3</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Treasury Notes</td>
<td>$15,290,373</td>
<td>-</td>
<td>-</td>
<td>15,290,373</td>
</tr>
<tr>
<td>Federal Agency securities</td>
<td>-</td>
<td>10,000,000</td>
<td>-</td>
<td>10,000,000</td>
</tr>
<tr>
<td>Negotiable CDs</td>
<td>-</td>
<td>9,197,337</td>
<td>-</td>
<td>9,197,337</td>
</tr>
<tr>
<td>Corporate Bonds</td>
<td>-</td>
<td>3,773,445</td>
<td>-</td>
<td>3,773,445</td>
</tr>
<tr>
<td>Total investments</td>
<td>$15,290,373</td>
<td>22,970,782</td>
<td>-</td>
<td>38,261,155</td>
</tr>
</tbody>
</table>

**NOTE:** Unless you include a reconciliation of investments NOT measured at fair value, this schedule will not agree to your other investment schedules.
The City categorizes its fair value measurements within the fair value hierarchy established by generally accepted accounting principles. The hierarchy is based on the valuation inputs used to measure the fair value of the asset. Level 1 inputs are quoted prices in active markets for identical assets; Level 2 inputs are significant other observable inputs; Level 3 inputs are significant unobservable inputs.

The City has the following recurring fair value measurements as of June 30, 20X1:

- U.S. Treasury securities of $45 million are valued using quoted market prices (Level 1 inputs)
- Corporate bonds of $12 million are valued using a matrix pricing model (Level 2 inputs).

The City also has a nonrecurring fair value measurement as of June 30, 20X1, for a closed performing arts hall that will no longer be used by the government and therefore is considered to be impaired. The hall has been written down from $5.6 million to $3.4 million based on an appraisal of the property (Level 3 inputs).
QUESTIONS