MPERS
GASB Statement 72

GASB and GAAP, Why Do They Matter?

The Governmental Accounting Standards Board (GASB) is an independent, private-sector organization that establishes accounting and financial reporting standards for U.S. state and local governments that adhere to generally accepted accounting principles (GAAP). The mission of GASB is to establish and improve financial accounting and reporting standards and guide and educate the public and users of those financial statements. GAAP is a common set of accepted accounting principles, standards, and procedures for organizations designed to improve financial reporting. The use of GAAP ensures transparency and a minimum level of consistency in organizations' financial statements leading to easier comparisons across all organizations. Financial statements must be prepared in conformity with both GASB standards and GAAP in order to receive a clean audit opinion. MPERS' success in following these standards, obtaining a clean audit opinion, and producing a quality annual report is substantiated by receipt of the Government Finance Officers Association Certificate of Achievement for Excellence in Financial Reporting, an award the system has received each year since 2005.

GASB Statement 72 – Fair Value Measurement and Application

GASB Statement 72 became effective in 2015 and MPERS incorporated it into the financial statements for Fiscal Year 2016. The statement requires certain investment assets and liabilities to be measured at fair value using a consistent definition of fair value, accepted valuation methodologies, and to be reported in a hierarchy table with additional note disclosures.

Leveling of Assets

In order to determine where the assets belong in the hierarchy, a level 1, 2 or 3 is assigned to each asset and liability based on the observability of a number of pricing/valuation inputs as of a specific measurement date.

- Level 1 assets have quoted values for assets or liabilities in an active market; the inputs are the prices for a set day (i.e., common stocks, preferred stocks, ETFs and futures contracts).
- Level 2 assets are based on inputs rather than direct prices, these include observed prices of similar assets (i.e., U.S. Treasuries, mutual funds and bonds or fixed income securities valued by pricing services) and may be the default placement if assets do not fall within level 1 or 3.
- Level 3 assets and liability values are more difficult to obtain on a regular basis and the inputs require verifications from outside parties, such as auditors or appraisers to validate the prices (i.e., real assets, and bonds that are traded less frequently).

With both levels 2 and 3, there can be a certain amount of subjectivity related to the inputs for those assets; it is important to note that subjectivity alone does not imply that the resulting valuations are inappropriate or inaccurate. Securities can also move between levels depending on how observable the inputs are on or around the measurement date. An example can be found in the internal fixed income portfolio. In 2017, a MoDOT bond that MPERS held was deemed a level 3 asset based on low trading volume the month leading up to the valuation process; however, in 2018, the same bond was moved to level 2, also due to trading volume.

Determining Asset Level

The entity issuing the report is responsible for assessing and determining the appropriate level for each asset held. In arriving at this conclusion, the asset must reasonably fit the description noted for one of the levels described above. The external auditor of the financial statements must also find the reporting reasonable. For MPERS' purposes, this leveling is determined as of June 30 each year, and has been outsourced to the custodial bank, Northern Trust. Northern Trust has established relationships with many pricing providers and has systems in place to analyze investment holdings. Considering the extensive resources and the knowledge base of Northern Trust and the complexity of this GASB statement, it is best practice to utilize an independent service provider such as Northern Trust to comply with the reporting standards.

Misconceptions of GASB Statement 72

An important detail of GASB Statement 72 is that asset levels are determined based on the unit of account at which the reporting entity is investing. This means for direct holdings – securities such as stocks and bonds that MPERS owns directly – the level is determined based on the inputs that go into the value of the stock or bond. However, for MPERS' fund investments, the fund itself is the unit of account and the level is assigned to the investment in the fund. Many of the funds that appear as level 3 assets on MPERS' financials will actually have underlying investments in level 1 and level 2 securities.

The unit of account methodology creates a challenge given MPERS' reliance on alternative (fund) investments. GASB Statement 72 offers little guidance for private market assets (private equity, real estate funds, etc.). Private market assets are valued using various methodologies including discounted cash flows, comparable market transactions, and comparable public company valuations. The valuation is determined utilizing consultants and third-party valuation firms, and is deemed to be the fair value if the asset were sold on that specific measurement date. Many other systems choose not to include alternative investments in the GASB Statement 72 hierarchy table, but instead include a separate table and additional footnotes in the annual financial report regarding these investments. MPERS, in an attempt to be as transparent and conservative as possible, made the decision to include all of the system's alternative fund assets as level 3 assets in the hierarchy table.

A common misconception is that the GASB Statement 72 hierarchy table is a reflection of the governmental entities' risk or liquidity profile. The "level" of the asset does not necessarily reflect the underlying risk or liquidity of the investment. For example, U.S. Treasury bonds are considered level 2 securities by most standards, and are considered among the safest and most liquid securities in the world. In fact, many of MPERS' level 2 and 3 securities are AA- or AAA-rated bonds that are very safe and can be traded the same day and/or trade on an exchange. For a complete liquidity analysis of MPERS' portfolio, please refer to the annual liquidity study that is provided by the general investment consultant. This liquidity study is reviewed annually by staff and MPERS' Board of Trustees to ensure there is ample liquidity in the portfolio to make benefit payments and maintain the targeted asset allocation.

Summary

GASB Statement 72 is one of many reporting standards that MPERS must comply with in completing our annual financial statements, but in practice has little impact on the management of the investment portfolio. The underlying risk profile of any system is not driven by the risk of any one security, but rather how the risk of all the underlying securities roll up to the entire portfolio. MPERS' investment staff makes each and every one of the fund's investments with a thorough understanding of the liquidity and valuation methodologies, as well as how that investment fits into the broader investment portfolio. Staff then continually monitors the valuation and progress of those investments as part of the ongoing due diligence process, and even serves on several advisory committees of MPERS' private market funds which provides further insight into the valuations of the underlying assets. The continuous oversight of the investment portfolio provided by MPERS' staff and external consultants provides far more insight into MPERS' risk and liquidity profile relative to the GASB Statement 72 reporting standards.