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# GASB Statement No. 31: Why No Controversy?

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## ABSTRACT

*Fair value reporting of investments in the financial statements of commercial enterprises is required under FASB Statement No. 115. The standard created much controversy when issued due to provisions that changes in fair values of certain investments were recognized in the operating statement. A major concern to many organizations was the volatility these recognized, but unrealized, changes in fair value would create in reported earnings. When the GASB issued Statement No. 31 requiring fair value reporting of investments there was little controversy concerning volatility to reported earnings of governmental entities, even though the standard required much broader application of fair value reporting. This study examined a possible explanation for the lack of controversy surrounding fair value reporting in the public sector. An analysis of the financial reports of the major U.S. municipalities provided empirical evidence of the significance of investments earnings to municipal revenues, investment assets to total assets, and the significance of changes in fair values of investments to investment earnings and total revenues. Financial reports and accompanying notes for fiscal years 1994 to 1998 were examined. Results indicate that overall, investments earnings were not a significant component of governmental fund revenues. However, investment earnings were significant for certain governmental fund types. The difference between costs and fair market values of investments also did not appear to be material to most governmental funds. The minimal impact of the fair value reporting on earnings offers a partial explanation for the lack of debate surrounding adoption of fair value reporting of investment by governmental entities.*

**Keywords:** fair value reporting, GASB 31, government investments, earnings volatility

## INTRODUCTION

*G*overnmental Accounting Standards Board (GASB) Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, has been hotly debated. In fact, some local and state governments have decided not to follow this guidance (for example, see Barkin 2007 and Wojcik 2007). Prior to GASB 45, new standards generally were not questioned, but instead quietly accepted as “just another requirement.”<sup>1</sup>

In March of 1995 the GASB issued statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools* (GASB 31). The standard requires governments to report investments at fair value in the balance sheet and changes in the fair value of investments reported as revenues or revenue reductions in the operating statement. The introduction of fair value reporting of investments potentially affected all governmental entities.

When the Financial Standards Accounting Board issued Statement No. 115 (FASB 115) in 1993, which required fair value reporting of investments for the private sector, there was considerable public criticism of the standard. One major concern expressed by various researchers studying the private sector response to FASB 115 was the volatility to earnings produced under fair value reporting. Some industries, such as banking and insurance, oppose reporting of investments at fair value because of the volatility introduced into reported earnings (for example, Simonson 1992, Hartman 1993, Razza 1993, Delay and Hauge 1994, Geissler 1995, Liouri 1997, Feay and

Abdullah 2001). Empirical studies conducted on selected commercial enterprises conclude that fair value reporting indeed added volatility to reported earnings (Barth, Landsman and Wahlen 1995, Yonetani and Katsuo 1998).

There was little public debate over provisions of GASB Statement No. 31, although it potentially affects both internal management and external users adversely. Critics claim that fair value reporting of investments in governmental fund financial statements distorts reported earnings by including unrealized gains and losses from changes in fair value. The volatility introduced into reported investment earnings may affect users' evaluations of financial position and condition. If this is true, then why was there so little debate? Does fair value investment reporting create significant volatility in investment earnings reported in governmental fund financial statements?

This research explores a potential reason why there was a general apathy to the effects of GASBS 31: the significance of investments to municipal operations. To determine the significance of investments to municipalities, and the significance of the effect of changes in fair values of investment on investment earnings, this study conducted an empirical analysis of financial statements for the largest U.S. municipalities.

## **METHODOLOGY**

To answer the questions of significance of investments to municipal financial results, a sample of pre-GASB 31 financial statements of the largest U.S. cities were analyzed. The analysis was conducted to determine the significance of investing activities to financial position and operating results. Note disclosures were analyzed to determine the significance of changes in fair value of investments to total investments and investment revenues.

## **DATA COLLECTION**

To gather information on municipalities that most likely would be significantly impacted by GASB 31, the largest 110 municipalities listed in the U.S. census of 2000 initially were selected for examination. Of the 110 selected, useable comprehensive annual financial reports or general-purpose financial statements for 107 municipalities were available for review.

Financial statements for fiscal years 1994 through 1997 were examined. This time period included the year before the GASB issued the exposure draft on fair value reporting for investments, through the year before implementation of the final pronouncement (i.e., GASBS 31). Financial statements issued by most municipalities after implementation of the standard do not display adequate information to conduct the analyses in this research.<sup>2</sup> A total of 400 observations resulted from the selection criteria.

Dollar amounts (rounded to thousands) for selected accounts were collected for the General Fund and all other governmental funds in total (i.e., Special Revenue Funds, Debt Service Funds, and Capital Projects Funds). Amounts collected included total assets, cash and investments, total revenues, and investment revenues.

The balance sheet account amounts were taken directly from the face of the statement of position. Investments included the balance sheet accounts of cash and cash equivalents and investments. The rationale for using cash in addition to cash equivalents and investments is two fold: (1) cash potentially could have been invested at year-end, and (2) many cities combined these accounts for balance sheet presentation. A measure of the significance of investments to financial position was computed by dividing total investments by total assets. The higher the percentage of investments to total assets, the more significant were investing activities.

A second measure of the significance of investing activities was the ratio of investments revenues to operating revenues. Operating revenues and investment revenues were collected for the General Fund and all other governmental funds from fund operating statements. The ratio of investments income to operating revenues indicated the significance of investing activities to operating results.

The significance of changes in fair values of investments to total investments was assessed by measuring the difference in cost of investments and fair value of investments at year-end. These amounts were collected from

the notes to the financial statements. Note presentation in every observation was at the total entity level, so analysis by fund or fund type was not possible.

An approximation of the impact of changes in fair value of investments on operating revenues was computed by allocating the change in fair value reported in the notes to fund investments and computing the change in fair value as a percent of revenues. This measure provided evidence of the degree of volatility fair value reporting introduced into reported operating revenues.

**SIGNIFICANCE OF INVESTMENTS**

The ratio of investments to total assets for all governmental funds indicates that cash and investments comprise a significant portion of total assets for each year analyzed. The mean percentage for investments as a percent of total assets for all cities over all years was 53%. Table 1 summarizes investments as a percentage of assets and investment revenues as a percent of total revenues for the General Fund and all other governmental funds for fiscal years 1994 through 1997.

The analysis reveals the amount of investments relative to total assets was significant for the cities reviewed. Results indicate reporting investments at fair value can potentially have significant impact on the financial position of a municipality.

**Table 1. Investments as a Percent of Assets and Investment Revenues as a Percent of Operating Revenues**

<u>Year</u>	<u>Investments as a Percent of Assets</u>		<u>Investments Revenues as a Percent of Op. Revenues</u>	
	<u>General Fund</u>	<u>Other Gov't Funds</u>	<u>General Fund</u>	<u>Other Gov't Funds</u>
1994	38%	66%	1%	19%
1995	37%	67%	1%	18%
1996	37%	65%	1%	20%
1997	36%	66%	1%	21%
All years	37%	66%	1%	20%

The ratio of investments to total assets for the General Fund was significant, with an overall mean percentage of 37% for all observations. Mean values by year were surprisingly consistent for years 1994 through 1997 with a maximum value of 38% in 1994 and a minimum value of 36% in 1997. The results indicate investments can be significant to the financial position of a municipal General Fund.

Other governmental funds include Special Revenues Funds, Capital Projects Funds, and Debt Service Funds. The mean value for other governmental funds for all cities over all years was 66%. Percentages remained consistent over the four-year period, with 67% maximum value in 1995 and a minimum value of 65% in 1996. The results indicated investments could be particularly significant to these fund types.

**SIGNIFICANCE OF INVESTMENT REVENUES**

An analysis of the ratio of investment revenues to operating revenues was conducted to determine if investment earnings were a significant source of revenues. Table 1 summarizes investment revenues as a percentage of total operating revenues for the General Fund and all other governmental funds.

Revenues generated from investments for the General Fund averaged 1% of operating revenues for each year reviewed. Other governmental funds investment revenues averaged 20% of operating revenues for all cities over all years. The highest mean occurred in 1997 with an average of 21% and the lowest mean of 18% occurred in 1995. The results indicate investment earnings were not significant to the operating results of the General Fund. Investment revenues were a significant source of revenues for other governmental funds. The findings indicate that significant changes in the fair value of investments could potentially have a material impact on reported operating results of governmental funds other than the General Fund.

**CHANGE IN FAIR VALUE OF INVESTMENTS TO TOTAL INVESTMENTS**

Analysis of the change in fair value of investments was limited to total entity investments because all cities reviewed reported investments at the entity level of detail. It was further limited to entities disclosing both cost information and fair value information. A total of 368 observations disclosed both cost and fair value amounts for investments. Column one of Table 2 summarizes the percentage difference in cost and fair value of investments at year-end and the change in fair value as a percent of operating revenues for the General Fund and all other governmental funds.

Of those reporting both amounts, 328 (89%) had some difference in amounts reported for cost and fair value. As a percent of total investments for all cities over all years, the average change in investments was less than 1% (0.9%) of total investments. The largest difference (1.6%) occurred in 1995 and smallest (0.3%) in 1997. The findings indicate that changes in fair values of investments of the cities reviewed did not materially affect reported investment amounts.

**Table 2. Percentage Difference in Fair Value and Cost of Investments and Change in Fair Value of Investments as a Percent of Revenues**

<u>Year</u>	<u>Difference in FV and Cost of Investments</u>	<u>Change in Fair Value of Investments as a Percent of Revenues</u>	
		<u>General Fund</u>	<u>Other Gov't Funds</u>
1994	0.8%	0.8%	5.4%
1995	1.6%	0.18%	4.7%
1996	1.0%	0.11%	4.4%
1997	0.3%	0.3%	4.6%
All years	0.9%	0.09%	4.6%

**CHANGE IN FAIR VALUE OF INVESTMENTS TO OPERATING REVENUES**

An approximate measure of the significance of the change in fair value to operating results was constructed to estimate the degree of volatility fair value reporting introduced into reported revenues. Because the change in fair value of investments was reported by total entity, the potential effect on governmental fund revenues could only be estimated.

An approximation of the effect of change in fair value on reported revenues was computed by using a two-step process. The ratio of fund investments to total entity investments was computed and same ratio used to allocate the change in fair value of total entity investments to fund investments. The amount of change in fair value allocated was then compared to total fund revenues to compute the change in fair value as a percent of operating revenues.

Results in Table 2 indicate the change in fair value of investments had essentially no impact on General Fund operating revenues, with an average change in fair value as a percent of operating revenues at less than a tenth of a percent. However, for other governmental funds the change in fair value had an impact on operating revenues for the years reviewed. The average change in fair value as a percent of total revenues averaged 4.6% over all observations. Results indicate the change in fair value of investments could potentially have at least some effect on operating results of these fund types.

**CONCLUSION**

The results of this study indicate that overall, investments earnings were not a significant component of governmental fund revenues. However, investment earnings may be significant for certain governmental fund types. More importantly, the difference between costs and fair market values of investments did not appear to be material

to most governmental funds. The minimal impact of the fair value reporting on earnings offers a partial explanation for the lack of debate surrounding adoption of fair value reporting of investment by governmental entities.

Although the earnings volatility may not be significant by usual “materiality” criteria, unexpected fluctuations can create political ramifications in the governmental environment. Citizenry, legislators, and the media are quick to question losses (and management competence), even if unrealized, especially in an election year or for governments experiencing financial distress. How finance directors and other government administrators explain even slight fluctuations in earnings due to fair value reporting is an open question and subject to future research.

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<sup>1</sup> A common reaction to GASB 31 as discussed in “The Usefulness of Fair Value Reporting in Governmental Funds,” a working paper by the same author.

<sup>2</sup> GASB 31 effectively eliminated cost information for investments under fair value reporting.

#### **AUTHOR INFORMATION**

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**NOTES**