January 29, 2018

Mr. David R. Bean
Director of Research and Technical Activities
Project No. 36
Governmental Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Dear Mr. Bean:

Members of the American Institute of Certified Public Accountants (AICPA) State and Local Government Expert Panel have reviewed the Governmental Accounting Standards Board (GASB) Exposure Draft (ED), *Accounting and Financial Reporting for Majority Equity Interests—an amendment of GASB Statement No. 14*, and are pleased to offer our comments.

We appreciate the Board taking on this project and support the Board's conclusion to give priority to the definition of an investment when evaluating the reporting of a government's majority equity interest in a legally separate organization. However, in reviewing the ED, many of our discussions centered on the lack of clear guidance of what is or is not an equity interest and the diversity in practice that currently exists. For this reason, we strongly recommend the Board provide comprehensive guidance on what constitutes an equity interest before issuing a final standard. Such comprehensive guidance is necessary for consistent application in the identification of, and accounting for, an equity interest, which will then provide a necessary foundation to evaluate the specific issues addressed by the ED. The "Significant Comments" section below provides further discussion of this issue, along with our other significant comments on the ED. The "Other Comments" section describes our less significant comments.

SIGNIFICANT COMMENTS

Comprehensive Guidance on What Constitutes an Equity Interest is Needed

Recommendation:

We recommend the Board provide comprehensive guidance on what factors should be considered in determining whether to report an equity interest in a legally separate entity.

Comment:

GASB's existing authoritative literature is unclear about when (or in which circumstance) an equity interest should be reported (recognized) in a legally separate entity. This results in diversity in practice considering the variety and complexity of legal structures used to establish the separate entities, including not-for-profit corporations, limited liability companies (LLCs), limited liability partnerships (LLPs), and limited partnerships (LPs). Some preparers default to a determination of whether an equity interest should be reported solely based on the type of legal structure.

The only definition of equity interest we are aware of is included in the following joint venture accounting guidance in paragraph .105 of section J50 of the GASB Codification of Governmental Accounting and Financial Reporting Standards (GASB Codification):

> *an equity interest in a joint venture is manifest in the ownership of shares of joint venture stock or by otherwise having an explicit, measurable right to the net resources of a joint venture that is usually based on an investment of financial or capital resources by a participating government.*

Legally separate entities are often established to provide public services that the primary government otherwise would have performed. The concept of ownership in these situations is challenging and may not be representative of the economic substance of the relationship between the government and the legally separate entity. Said another way, the interest in the legally separate entity may not embody or be reflective of the characteristics of an asset as defined in GASB Concept Statement No. 4, *Elements of Financial Statements*. Even if there is an "ownership interest" in the legally separate entity, the primary government may not receive any direct financial benefit from ownership. It is unclear whether this type of arrangement should be considered an equity interest.

Further complicating the issue is what should be considered an equity interest because it represents consideration paid for an ownership interest (asset) as opposed to what should be considered to be routine financial support with no expectation of future return (expense). This is simplified when consideration is paid to a third party for the acquisition of an existing entity. However, most legally separate entities are not acquired, but rather are established by the government(s) that potentially have an ownership interest in them.

Accordingly, additional guidance to address what factors to consider in determining whether there is an equity interest that meets the definition of an asset (i.e., resources with present service capacity that the government presently controls) is necessary for consistent application. Such guidance should include a definition of equity interest beyond what is currently included in GASB's literature for joint ventures.

Component Unit Criteria for Majority Equity Interests Should be Eliminated

Recommendation:

We recommend the Board eliminate the "de facto" criteria that requires a government to report a legally separate entity as a component unit when it owns a majority equity interest that does not meet the definition of an investment and instead default to the accountability criteria in GASB Statement No. 14, *The Financial Reporting Entity*.

Comment:

Paragraph 6 of the ED requires that a primary government's holding of a majority equity interest in a legally separate organization that does not meet the definition of an investment be reported as a component unit. This criteria does not appear to be consistent with the Board's fundamental view in GASB Statement No. 14 that the financial reporting entity concept should be based primarily on accountability (as opposed to control). As further discussed below, holding a majority equity interest does not always equate to financial accountability.

We acknowledge that the proposed guidance in paragraph 6 of the ED is based on existing GASB guidance. This "additional" or "expanded" reporting entity criteria (that is, holding a majority equity interest) was originally added with the amendments introduced in GASB Statement No. 61, *The Financial Reporting Entity: Omnibus.* However, given that the focus of the amendments to GASB Statement No. 61 was to require the primary government to report (recognize) an equity interest in a discretely presented component unit for the first time, we did not recognize the subtle amendment to change the requirement for reporting a component unit based on owning a majority of the "voting stock of a for-profit corporation" to holding or owning a majority "equity interest" in a broad variety of organizational structures.

Instead of the ED's approach in paragraph 6, there are more relevant criteria in GASB Statement No. 14 that are indicative of accountability, including appointment of a voting majority of the Board and fiscal dependence. Accordingly, we believe the financial accountability criteria included in GASB Statement No. 14 are adequate and appropriate for evaluating potential component unit relationships.

We also identified a potential conflict with existing guidance (Questions 4.18.11 and 4.9.5 of *GASB Implementation Guide 2015-1*). Consider a situation in which Government A owns 1% of an LP and serves as general partner and Government B owns 99% of an LP with limited rights regarding the operation of the partnership. Under 4.18.11, Government A would report the LP as a component unit as the question cites that acting as the general partner is tantamount to appointing the board (there is no discussion of the ownership stake). However, 4.9.5 would have Government B report the LP as a component unit as the question addresses ownership interest but not accountability. Thus, the existing guidance in the Implementation Guide should be reconsidered to address accountability rather than control.

Additional Guidance is Necessary to Address Financial Accountability in Various Legal Structures

Recommendation:

Assuming the Board agrees with our recommendation to eliminate the component unit criteria for equity interests, we also recommend the Board develop, concurrently with the issue discussed above, additional interpretative guidance to address financial accountability criteria with respect to the various legal structures used to establish separate entities (for example, LLCs and LLPs).

Comment:

We believe that additional guidance is necessary to evaluate the financial accountability criteria in GASB Statement No. 14 for the various legal structures of the entities for which a government holds an equity interest in, including LLCs and LLPs.

For example, in the case of an LLC, currently it is not clear how to evaluate the financial accountability criteria for appointment of a voting majority of the board. LLCs often have significant flexibility in how they are established, including whether there is:

- a separate governance structure similar to a corporation (that is, a board of directors),
- a separate management committee or management powers assigned to certain member(s) (similar to a general partner in an LLP), or
- no designated governance or management structure in the case of certain sole member LLCs.

Additional guidance is necessary to determine how to evaluate whether the primary government meets the criteria of appointment of a voting majority of the board in these circumstances, for example a government's collective decision-making and oversight authority is equivalent to appointment of a voting majority of the Board.

Scope of Guidance for Equity Acquisitions Should be Expanded to Acquisitions of More than 50% Equity Interest

Recommendation:

We strongly recommend the Board not proceed with issuance of the guidance in paragraph 7 of the ED until it fully considers the appropriate accounting for circumstances in which the government acquires more than 50 percent but less than 100% equity interest that is reported as a component unit.

Comment:

Paragraph of 7 of the ED requires that if a primary government acquires a 100 percent equity interest in a legally separate organization that is reported as a component unit in accordance with paragraph 6, the component unit should measure its assets, deferred outflows of resources, liabilities, and deferred inflows of resources in accordance with the provisions of paragraphs 29–42 of GASB Statement No. 69, *Government Combinations and Disposals of Government Operations*, as amended, at the date on which the primary government acquired the 100 percent equity interest. This is a significant change from the extant accounting guidance (continuing/carryover basis of reported amounts) and would result in a "step-up" of the reported financial statement amounts based primarily on the acquisition amount on the date of acquisition.

Although the guidance included in paragraph 7 of the ED for acquisitions of a 100% equity interest may appear reasonable, we believe that other considerations may arise when deliberating the appropriate accounting for acquisitions of less than 100% equity interest. We are also concerned about the differences in accounting that will exist in the interim, even when there is no substantial economic difference in the acquisition (for example, a 100% acquisition vs. a 99.9% acquisition).

Thus, we believe aligning deliberations of a 100% acquisition equity interest with the Board's current project, "Acquisition of Less-Than-100-Percent Equity Interest in Component Units" will provide a better outcome given the Board's comprehensive consideration of all acquisitions of 50% or more, rather than separate deliberations of similar scenarios.

Fair Value is Most Relevant Measurement Attribute for Ownership Interests that Meet the Definition of an Investment

Recommendation:

We recommend all equity interests in a legally separate organization that meet the definition of an investment be reported at fair value.

Comment:

We believe *fair value* is the most relevant measurement attribute for most investments, including majority equity interests as opposed to the equity method cited in paragraph 4 of the ED and suggest the Board modify paragraph 4 accordingly. Consistent with the Board's view in GASB Statement No. 72, *Fair Value Measurement and Application,* we believe fair value measurements provide consistency and comparability to the reporting of items that are held as investments. Fair value also provides for more decision-useful information to users than other cost-based measurement attributes, or in the case of equity method accounting, the mixed attribute model of the underlying financial statements prepared in accordance with generally accepted accounting principles (GAAP) of the legally separate entity.

The rationale provided in paragraph B7 of the basis for conclusions of the ED (included below) does not address the fundamental question of which measurement attribute is most appropriate. Instead, it makes reference to the accounting requirements in GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contain in Pre-November 30, 1989 FASB and AICPA Pronouncements*, for investments in common stock that give the government the ability to exercise significant influence over operating and financial policies of the investee (that is, usually when the government owns between 20 and 50 percent of the common stock).

> *B7. After considering the various ways in which a majority equity interest in a legally separate organization was being measured, the Board determined that the measurement of a majority equity interest in a legally separate organization that meets the definition of an investment <u>has similar characteristics to an investment in common stock and therefore should be measured in a similar manner</u>. As a result, this Statement requires application of the equity method in Statement 62 to measure a majority equity interest in a legally separate organization, except for circumstances in which the majority equity interest is being held by a special-purpose government engaged only in fiduciary activities, a fiduciary fund, or an endowment (including permanent and term endowments) or a permanent fund. In those circumstances, the majority equity interest should be measured at fair value.*

We also believe the ED will lead to inconsistent measurement based on the nature of the underlying GAAP financial statements of the legally separate entities. For example, a government investor owning an equity interest in an investment company which reports assets and liabilities primarily using a fair value model will result in a measurement that approximates fair value (similar to the concept of net asset value as practical expedient discussed in GASB Statement No. 72). In contrast, a government investor owning an equity interest in an operating company which reports assets and liabilities using a mixed attribute model will result in a measurement significantly different than fair value that will more closely resemble a cost-based measurement (adjusted for results of operations).

OTHER COMMENTS

Codification Instructions for Paragraph 7 Need Revision. The ED refers to the guidance in paragraph 7 as "component unit reporting guidance" that amends GASB Statement No. 14, and indicates the guidance will be codified in section 2600, Reporting Entity Presentation and Disclosure, of the GASB Codification. We disagree with this approach since paragraph 7 is "recognition and measurement guidance" related to a specific type of government combination and not component unit reporting guidance. We believe that a government seeking acquisition and measurement guidance for a transaction of this nature would not look for it in "component unit reporting guidance" and could potentially overlook the guidance. Therefore, we recommend it be included in section Co10, Combinations and Disposals of Operations, of the GASB Codification because we believe a government would likely look to that section first.

Scope of Acquisition Guidance in Paragraph 7 Unclear. We recommend the Board clarify whether the guidance in paragraph 7 applies only to situations involving purchases of equity interests, or whether it would also apply to acquisitions accomplished by other means (for example, by donation). If it is limited to equity interests that are acquired by purchase, the first sentence of paragraph 7 should be clarified. We also recommend the Board clarify whether the proposed accounting would apply to all such transactions that involve an exchange of consideration, or whether it would apply only to transactions where the amount of consideration exchanged is "significant" (consistent with the existing requirement in GASB Statement No. 69).

Applicability of Guidance on Step Acquisitions Needs Clarification. The second sentence of paragraph 7 of the ED requires that preexisting equity interest assets be treated as part of the acquisition price in a 100% acquisition that occurs in steps across periods. We are unclear as to whether this guidance applies only to preexisting "majority" equity interest assets or any equity interests (including those previously recorded based on significant influence). Thus, we recommend the Board clarify the accounting when a government holds an interest that is 50% or less and subsequently acquires a 100% stake.

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The AICPA appreciates the opportunity to comment on the ED. This comment letter was prepared by members of the AICPA's State and Local Government Expert Panel with input from the AICPA's Healthcare Expert Panel and was reviewed by representatives of the Financial Reporting Executive Committee who did not object to its issuance. Representatives of the AICPA would be pleased to discuss these comments with you at your convenience.

Sincerely,

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Chair
AICPA State and Local Government
Expert Panel

Mary M. Foelster
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cc: State and Local Government Expert Panel
James Dolinar
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