



July 20, 2010

Mr. David R. Bean  
Director of Research and Technical Activities  
Project No. 3-14  
Governmental Accounting Standards Board  
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Dear Mr. Bean:

The American Institute of Certified Public Accountants (AICPA) has reviewed the Governmental Accounting Standards Board (GASB) Exposure Draft (ED), *The Financial Reporting Entity an Amendment of GASB Statements No. 14 and 34*, and is pleased to offer its comments. Overall, we support the GASB's objective to improve the financial reporting for a governmental financial reporting entity. However, we do have several significant comments and recommendations, particularly with regard to the proposed blending criteria, that we believe the Board should consider before finalizing the standard. Our significant comments and recommendations are included in the following section of this letter and our other comments are in the "Other Comments and Recommendations" section below. Additionally, the Appendix to this letter provides several examples of our concerns relating to differing views in the proposed blending criteria.

#### **SIGNIFICANT COMMENTS AND RECOMMENDATIONS**

***Limitations in the Scope of the Exposure Draft.*** We are disappointed the Board did not include clarifying guidance for the requirement in paragraph 19 of GASB Statement No. 14, *The Financial Reporting Entity*, that governments include fiduciary activities as trust funds if the primary government has fiduciary responsibility for them. Similarly, we are disappointed that the Board did not provide requirements and guidance for separately issued financial statements for reporting units that comprise less than a separate reporting entity. We understand from the discussion in Appendix A of the ED that the Board scoped these topics out of this project because they were broader than reporting entity considerations. However, for the reasons cited in the next two paragraphs, we highly encourage the Board to take on these topics in separate projects in a timely manner.

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The requirement in paragraph 19 of GASB Statement No. 14 has resulted in diversity in practice due to preparers interpreting it differently. This is primarily due to the lack of guidance from GASB related to fiduciary activities and fiduciary responsibilities. We believe that additional guidance is needed in this area and that such guidance would provide more consistent reporting of fiduciary activities.

Further, as we have stated previously to the Board, we continue to believe that there is a need for generally accepted accounting principles (GAAP) for separately issued financial statements for reporting units that comprise less than a separate legal entity. As the Board is aware there is a frequent, often legal, need for certain governments to issue individual fund and departmental financial statements. Many questions have arisen about whether governmental entities can issue separate fund and departmental financial statements, what such financial statements should include, and whether they would constitute a presentation in conformity with GAAP. We recommend that the Board address these questions directly by providing requirements and guidance for separate fund and departmental financial statements, including which provisions of GASB Statement No. 34, *Basic Financial Statements – and Management’s Discussion and Analysis – for State and Local Governments*, would apply.

***Criteria for Blending Component Units.*** Page v of the ED states that the proposed amendments to the criteria for blending would improve the focus of a financial reporting entity on the primary government by ensuring that the primary government includes only those component units that are so intertwined with the primary government that they are essentially the same as the primary government, and by clarifying which component units have that characteristic. While we agree the blending criteria in paragraph 53 of GASB Statement No. 14 needed to be reconsidered by the Board, we believe that the proposed amendments in paragraph 8 of the ED do not fully accomplish this. Our observation in applying the “substantively the same governing body” blending criteria of paragraph 53(a), which is not changed by the ED, is that the blending of component units does not occur often, as apparently has been intended by the Board. However, our view is that governmental financial statement users are actually misled by the discrete presentation of a component unit when the primary government has the ability to control that component unit. Based on this view, we recommend that the primary government’s financial statements include all of the activities for which their elected officials have control and are therefore responsible for. Ultimately, we differ from the Board in that we believe that the blended presentation of component units should be much more common.

The proposed blending criteria base the decision to blend on whether the component unit is, in form, part of the primary government, rather than in substance. We believe that these criteria are flawed as they neglect to require blending in a situation where control is provided through legal powers vested in the governing documents (for example, articles of incorporation). In our judgment, a

primary government's ability to control a component unit makes the component unit significantly intertwined with the primary government. We noted that paragraph 8 of the ED would permit a blended presentation only if the component unit's governing body is substantially the same as the governing body of the primary government rather than the potential for it to be substantially the same. Several members of our Panel raised situations where a component unit meeting the criteria for discrete presentation could be changed to a blending presentation simply because the primary government exercises its ability to replace board members. The substance of the relationship between the primary government and the component unit would not have changed, just the physical composition of the board. Based on the importance of a substance over form focus, we believe that the primary government's ability to appoint or change the governing board should result in blending treatment. Therefore, we recommend that the proposed blending criteria be further revised such that the requirement to blend would also be based on the *ability* of the primary government to exercise its control over a component unit rather than the actual exercise of control.

In light of our concerns, we suggest that the proposed criteria in paragraph 8 of the ED be revised. We recognize that our proposal would result in more component units being blended, but believe that this is appropriate for component units that are, in substance, the same as the primary government. We have marked (i.e., shown in **red bolded font**) our proposed revisions to what appears in paragraph 8 of the ED for paragraph 53 of GASB Statement No. 14 below. The section immediately following our marked revisions provides our rationale for each proposed change. We support the proposed changes to subparts (b) and (c) of paragraph 53 as presented in paragraph 8 of the ED.

53. A component unit should be included in the reporting entity financial statements using the blending method in any of these circumstances:

- a. The component unit's governing body is **comprised entirely of members from substantively the same as** the governing body of the primary government **and/or its management or employees** and (1) there is a financial benefit or burden relationship between the primary government and the component unit, as described in paragraphs 27-33 or (2) management of the primary government has operational responsibility for the component unit. Management of a primary government has operational responsibility for a component unit if it **is responsible for managing manages the activities of the component unit in essentially the same manner in which it manages its own programs, departments, or agencies**. Management, for purposes of this determination, consists of the person(s), below the level of the governing board, responsible for the day-to-day operations of

the primary government (for example, a county executive or city manager).

**b. The primary government has control of the component unit's activities and the component unit exists to perform activities or provide services that the primary government would have performed itself, if the component unit did not exist and there is a financial benefit or burden relationship between the primary government and the component unit. The primary government has control of the component unit's activities if any of the following exists:**

- **The primary government appoints a voting majority of the component unit's governing board and has the ability to remove component unit board members at will and replace with members of the primary government's governing board, management, or other appointed officials external to the government that are appointed to serve the interest of the primary government.**
- **The primary government has a majority ownership of a for-profit component unit.**
- **The primary government is the sole shareholder or corporate member of a not-for profit component unit.**

**b. c.** The component unit provides services entirely, or almost entirely, to the primary government or otherwise exclusively, or almost exclusively, benefits the primary government even though it does not provide services directly to it. The essence of this type of arrangement is much the same as an internal service fund—the goods or services are provided to the government itself rather than to the citizenry. Usually the services provided by a blended component unit are financing services provided solely to the primary government. For example, a building authority may be created to finance the construction of office buildings for the primary government. However, a component unit that provides services to more than just the primary government should also be blended if the services provided to others are insignificant to the overall activities of the component unit. Other component units that should be blended are those that exclusively, or almost exclusively, benefit the primary government by providing services indirectly; for example, a component unit that provides services on behalf of the primary government to its

employees rather than directly to the primary government itself.

- e.d.** The component unit's total debt outstanding, including leases, is expected to be repaid entirely or almost entirely with resources of the primary government. Repayment generally occurs through a continuing irrevocable pledge and appropriation by the primary government to the component unit that, in turn, pledges those appropriation payments to bondholders as the primary source of repayment for its debt.

*Composition of Governing Boards.* We suggest changing the proposed criterion in paragraph 53(a) from a governing body that is substantially the same to one that is comprised *entirely* of members from the governing body of the primary government *and/or its management or employees* to make the guidance more clear and to reflect the control aspects of the primary government over the component unit. Further, our revision to include management or employees of the governing body is made because the presence of the primary government's own board, management, or employees on the component unit's board intertwines the entities because of the potential influence the primary government could exert. We believe these changes, in conjunction with our other proposed changes to the criteria, produce a better model for blended presentation.

*Operational Responsibility for Component Units.* We suggest expanding the concept of operational responsibility in the proposed revision to paragraph 53(a) to include arrangements for which the primary government is responsible for the management of the activities of the component unit but may not be directly involved in aspects of day to day management. Currently, the blending method is dependent upon the management of the primary government having operational responsibility for the component unit, which we support. However, the Board's clarifying language added to the latter part of the paragraph seems to inappropriately exclude entities that outsource management of a component unit to a management company or other cases where a city manager or county executive is responsible for independently managed departments. Thus, our additional revision to paragraph 53(a) would require blended treatment for entities that maintain responsibility for the management of component unit activities rather than just for entities that directly manage the activities of component units.

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*Ability to Appoint and Remove Governing Members At Will.* Our proposed addition to paragraph 53 (see our new paragraph 53(b) above) would require blending when the primary government has the *ability* to appoint and remove governing members *at will*. As GASB Statement No. 14 is currently written, primary governments that have the ability to remove a component unit's governing body and appoint new members at will have different presentations depending on whether that ability is exercised. As noted earlier in this letter, we believe that the substance of the relationship is the ability to appoint or remove a governing board at will, not the action to appoint or remove a board. In our view, the ability alone constitutes control by the primary government over the component unit.

*Governmental Relationships Based on Legal Ownership.* Our proposed addition to paragraph 53 (see our new paragraph 53(b) above) addresses legal ownership considerations which we believe are necessary. While paragraph 55 of GASB Statement No. 14 does make some reference to corporate ownership, neither GASB Statement No. 14 nor this ED address governmental component unit relationships (as opposed to investments) that exist based on legal ownership. Corporate structures are common, particularly among governments involved in business-type activities (BTAs). GASB Statement No. 14 focuses primarily on defining the reporting entity in terms of overlaps and relationships between "bodies corporate and politic" created by a legislature, and only makes brief references to component units that are incorporated under state corporation laws. In our view, the reporting entity will not have been comprehensively reconsidered in the course of this project unless the Board addresses relationships involving legal ownership.

The Appendix to this letter includes more discussion and some illustrative examples to expand upon on our concerns pertaining to blending.

Finally, if the Board rejects our comments above the Board should include the rationale for not further revising the blending criteria in the final Statement Basis for Conclusions.

***Impact of the Blending Criteria Amendments.*** If the Board rejects our proposals noted in the previous comment to alter the blending criteria and maintains paragraph 53(b) as presented in the ED, we question whether the Board has considered the impact for certain entities such as lotteries and tribal gaming entities. We believe that the existing criterion (which is unchanged by the ED) addressing the provision of services by a component unit "entirely, or almost entirely, to the primary government or otherwise exclusively, or almost exclusively benefits the primary government" would generally result in blending lotteries and tribal gaming entities. While we agree with blending for these entities, we are unclear whether this is the Board's intention. In previous consultations on this criterion with GASB staff, there have been differing interpretations provided on whether to present such component units using discrete or blended presentation. This should be clarified by the Board.

***Consolidation of Blended Component Units for BTAs.*** Paragraph 9 of the ED, which would revise paragraph 54 of GASB Statement No. 14, states that for governments engaged only in BTAs that use a single column for financial statement presentation, a component unit may be blended by consolidating its financial statement data within the single column of the primary government and presenting combining information in the notes to the financial statements. We believe that this proposed revision is too restrictive. The amendment appears to permit consolidation only for BTAs that use a single column for financial statement presentation. This would create different presentations for BTAs with blended component units depending on whether they are issuing stand-alone financial statements (consolidate the blended component unit) or are reported within a larger financial reporting entity (not consolidate the blended component unit). We believe that the financial presentation of a BTA should be consistent regardless of its reporting structure and would support the consolidation of a blended component unit into a BTA. Therefore, we suggest the Board modify its revision to paragraph 54 of GASB Statement No. 14 to expand this consolidation treatment for the BTA when it is reported within a larger financial reporting entity.

#### **OTHER COMMENTS AND RECOMMENDATIONS**

***Financial Accountability Criteria.*** In reviewing the proposed amendments to paragraph 21 of GASB Statement No. 14 (paragraph 6 of the ED), we question whether the financial accountability concepts in paragraphs 21(a) and 21(b) are appropriately worded. Paragraph 21(a) states that “The primary government is financially accountable if it appoints a voting majority of the organization’s governing body *and* (1) it is able to impose its will on that organization *or* (2) there is a potential for the organization to provide specific financial benefits to, or impose specific financial burdens on, the primary government.” Thus, paragraph 21(a) permits no judgment in assessing accountability if the criteria presented are met. However, paragraph 21(b) states that “The primary government may be financially accountable if an organization is fiscally dependent on *and* there is a potential for the organization to provide specific financial benefits to, or impose specific financial burdens on, the primary government regardless of whether the organization has (1) a separately elected governing board, (2) a governing board appointed by a higher level of government, or (3) a jointly appointed board.” In reviewing the amendments to paragraph 21(b) we noted that judgment is permitted in assessing accountability when the stated criteria are met as it says the primary government *may be* financially accountable. We believe that an organization that is fiscally dependent on the primary government and there is potential to provide specific financial benefits to, or impose specific financial burdens on the primary government is financially accountable and thus recommend that paragraph 21(b) be changed to be definitive (i.e., ‘the primary government *is* financially accountable’).

***Concept of Consolidation for Other Than BTAs.*** In deliberating the proposed changes to paragraph 54 of GASB Statement No. 14 in paragraph 9 of the ED, many of our members questioned why the consolidated presentation of a blended component unit was limited solely to BTAs. We believe the consolidated presentation should be expanded to other funds beyond BTAs and encourage the Board to evaluate whether this concept could be expanded in such a manner.

***References to Ownership Relationships.*** GASB Statement No. 14 refers to ownership relationships only in terms of 'stock.' BTAs increasingly are utilizing limited liability corporation structures which may have the characteristics of either a partnership or a corporation. The final Statement should clearly address a variety of ownership situations and what they mean within the context of 'financial accountability.'

***"Acquisition of Equity Interests" Versus "Ownership" Of Component Units.*** The proposed revisions to paragraph 55 of GASB Statement No. 14 in paragraph 10 of the ED change the framework to present an equity interest as a component unit or an investment from *ownership* to *acquisition of equity interest* in an entity. We believe that ownership is the critical factor and not the method of creation of such an interest (for example, internally created, acquired, or combined). The proposed revisions appear to limit the equity interest guidance in paragraph 55 to only those interests acquired. We suggest that the Board frame the guidance in terms of ownership. If the Board maintains the 'acquisition' language, we suggest the Board clarify its intentions of this change in the Basis for Conclusions and modify the heading to paragraph 55 of GASB Statement No. 14 to "Acquired Equity Interests in Component Units."

***Lack of Clarity Around Equity Interest Presentation.*** To some members reviewing the ED, the accounting treatment for equity interests described in the proposed revisions in paragraph 10 of the ED to paragraph 55 of GASB Statement No. 14 was not clear. The proposed revisions to paragraph 55 state, "If the government's intent in acquiring a majority equity interest is to directly enhance its ability to provide governmental services, the organization should be reported as component unit. The equity interest should be reported as an asset of the fund that has the equity interest." A number of our members were unclear about the presentation that would result when the component unit is discretely presented and questioned whether a separate asset would be reported in the fund and whether this would create double counting of the component unit (as a discretely presented component unit and as an asset on the fund of a primary government that acquired the equity interest). We support such a presentation, but suggest that the Board clarify whether this is the intent.



**Potential for Dual Inclusion.** In discussing the proposed changes to paragraph 38 of GASB Statement No. 14 in paragraph 6 of the ED, we noted that Board revised the school district example illustrating the potential inclusion in more than one reporting entity. The conclusion of the example states that fiscal dependency on a local government should govern in determining the appropriate reporting entity of such school districts. We were unclear why the Board struck the notion that the financial burden on the state created by legislatively established aid distribution formulas is not the governing factor. We ask that the Board clarify its intent of this deletion in the Basis for Conclusions.

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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 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,



James C. Lanzarotta  
Chair  
AICPA State and Local Government  
Expert Panel



Mary M. Foelster  
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cc: State and Local Government Expert Panel  
Jay Hanson  
Daniel Noll

**EXAMPLES TO ILLUSTRATE CONCERNS PERTAINING TO BLENDING**

As discussed in the “Significant Concerns and Recommendations” section of our letter we believe that the proposed amendments in paragraph 8 of the ED to the blending criteria in paragraph 53 of GASB Statement No. 14 do not fully address the objective stated in the ED for revising the criteria. We have provided a number of examples in this Appendix to illustrate the flaws of the currently proposed blending criteria.

**University Example.** A state university operates a teaching hospital. The teaching hospital is operated as a separate department of the university in that it has separate management, but it is not a separate legal entity. Assume the state university creates a separate not-for-profit corporation for the teaching hospital over which it is the sole corporate member, thus it has the ability to appoint and remove the board at will. Also assume that the university establishes a seven-member board for the hospital corporation consisting of five members of the university’s board plus a community member and a physician. In this situation, the state university has absolute power over the hospital corporation created. Thus, there is no need to address the representation of the university’s board on the corporation’s board because no matter how many overlapping members serve on the board, the university has absolute control based on its ability to appoint and remove the board. Such a structure allows the university unilateral ability to present the assets and operation of the hospital as a separate, 100% controlled corporation, as well as the power to dissolve that corporation and bring the assets and operations back into the university’s legal entity, if it desires. Using the blending criteria in the ED, the university could manipulate and distort its financial reporting by making the hospital a separate corporation and creating a board that is not substantially the same. This would move the assets and operations of the hospital out of the primary government financial statements and into a discretely presented component unit. Later, if the university were to dissolve the corporation, the assets and operations would be brought back into the primary government. The university’s day to day control over the hospital operations does not change with the existence of the not-for-profit corporation, but the picture of the university’s financial position and results of operations could dramatically change. Using our proposed changes to the blending criteria in paragraph 53, the operations of the hospital would be blended if the not-for-profit corporation were created.

This scenario is further complicated if the hospital, which operates as a department, provides a significant amount of cash to support the operations of a medical school (also operated by the state university). The hospital operation would be closely integrated with the medical school operation. This would be true whether the hospital was in the form of a department or a not-for-profit corporation. Given the criteria in paragraph 53(b) of the ED, it could be very confusing to decide whether the component unit “provides services entirely, or almost entirely, to the primary government or otherwise exclusively, or almost exclusively, benefits the primary government...” Clearer guidance is necessary to apply these concepts within the context of an ownership relationship and we believe that our suggested amendments to paragraph 53 achieve this.

***Tribal Casino Example.*** A tribal primary government (Tribe) establishes a casino entity in the form of a federally chartered corporation (Corporation) to conduct gaming activities and certain related activities including food, beverage and lodging. Through its governing body (Tribal Council) the Tribe determines the size of the Corporation's board, appoints the initial board, retains the responsibility to approve future appointments to the board, and has the right to remove any board member. Three of the twelve members of the Tribal Council are appointed to serve on the Corporation's initial seven member Board. The Tribe assigns to the Corporation its interest in certain land held in trust by the federal government for the benefit of the Tribe to facilitate gaming and related activities of the Corporation.

The activities of the Corporation will directly benefit the Tribe and the members by financing per capita distributions and services provided by the Tribe to its members. The Tribe would have performed the activities related to the casino if the Corporation did not exist. It is expected that the success of gaming and related activities will be enhanced by conducting such activities through an enterprise fund of the Tribe.

Using our proposed changes to paragraph 53 of GASB Statement No. 14, the Corporation would be blended because the Tribe has control over the Corporation; the Tribe would have performed the activities related to the casino absent the Corporation; and a financial benefit relationship between the Tribe and the Corporation. However, using the amendments to the blending criteria proposed by the Board would result in different presentations depending on the composition of the Corporation's board and whether the Tribe considers the casino operations as benefitting the primary government.

***Supporting Organization Example.*** A primary government establishes a supporting organization (SO) in the form of a not-for-profit entity to advance certain initiatives of the primary government. The primary government appoints the initial board to the SO and retains the responsibility to approve future appointments to the Board made by the SO. Additionally, the primary government has the right to remove any SO board member.

The activities of the SO directly benefit the primary government and the citizens it serves. However, the activities are not provided directly to the primary government as a 'customer' of the SO. The primary government assigns certain intellectual property, patents, and experience of its employees to the SO, and certain primary government employees become employees of the SO. It is expected that the SO will be better able to further the development of these assets as a separate organization from the primary government. However, the primary government expects to benefit from the efforts of the SO through revenue sharing on the assigned assets, and the ability to increase its own revenues or reduce expenses as a result of further knowledge or experience of the SO garnered from the SO's activities.

The Board's proposed changes to the blending criteria could result in no component unit reporting for the SO or a discrete presentation, depending on a further evaluation of the 'financial benefit/burden' criterion. We believe this relationship would be best presented as a blended component unit given the primary government's ability to control the board of

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the SO, and that the intent is for the primary government to benefit from the activities of the SO even though it will not be a direct 'customer' of the primary government. Our proposed changes to paragraph 53 of GASB Statement No. 14 would clarify that the ability of the primary government to control the board through its responsibility to approve board members and its right to remove board members, coupled with the expectation that it will directly benefit from the activities of the SO, would result in a blending presentation.