

# **GASB Limits Flexibility in Reporting on Affiliated Organizations**

## *A Look at the Process and How NACUBO Sought to Influence the Result*

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The Governmental Accounting Standards Board (GASB) in May 2002 issued a new standard, revising the criteria to define a component unit. This statement – the culmination of over 10 years of work by the GASB to research and determine the best way to define and report on component units – changes the way much of higher education will report these entities on financial statements. Statement No. 39 will dramatically affect the flexibility in reporting of legally separate, tax-exempt organizations related to public colleges and universities.

In examining the new standard, this paper also provides background to help readers understand the end result and details NACUBO's, and its Accounting Principles Council's, role in the process and how the association sought to influence the result.

### **HISTORY**

When GASB established a project on the definition and reporting of affiliated organizations in the late 1980s, it had a rich history to consider. The National Council on Governmental Accounting (NCGA), the GASB's predecessor organization, had provided guidance on the reporting entity in NCGA Statement 3, *Defining the Governmental Reporting Entity*; NCGA Statement 7, *Financial Reporting for Component Units within the Governmental Reporting Entity*; and, NCGA Interpretation 7, *Clarification as to the Application of the Criteria in NCGA Statement 3, "Defining the Governmental Reporting Entity."*

Ultimately, the effort led to the issuance of GASB Statement No. 14, *The Financial Reporting Entity*, in June 1991. The standard in Statement No. 14 includes a reference to the need for additional research to resolve a key issue affecting the financial reporting by some governments, including public colleges and universities. Paragraph 41 states: "The GASB is studying circumstances under which foundations, similarly affiliated organizations, and PERS might be included in the financial reporting entity. Appropriate pronouncements will be issued at a later date."

It took 10 years for that later date to arrive with the issuance in May 2002 of Statement No. 39, "Determining Whether Certain Organizations Are Component Units, an amendment of GASB Statement No. 14." It is unlikely that any single issue has taken as long to resolve as this one.

The majority of the guidance provided in Statement No. 14 is relatively straightforward. The basic governmental unit is defined and criteria are provided for determining when to include other organizations or entities as part of the governmental reporting unit. Several specific criteria are identified, including characteristics such as financial accountability, appointing a majority of board members, imposition of will, and financial benefit to or burden on a government.

Based on the criteria, entities may be blended with the government (i.e. if they are essentially a part of or exist almost exclusively for the benefit of the primary government), or otherwise presented as a component unit through discrete display. A blended presentation is one in which the governmental unit's financial results are combined with those of another entity, such that only the combined results are presented. It is not possible to discern separate information about either the government or the affiliated organization in a blended presentation. Discrete display, on the other hand, results in separate columns for the primary government and any component units. In this approach, details about the government and its affiliates are apparent because each is presented separately. GASB 14 provided that affiliated organizations that did not meet the definitional criteria of a component unit for combined financial reporting should be evaluated as a potential component unit if they were closely related to the primary government. Institution managers could use their professional judgment to determine whether

the nature and significance of the affiliated organization's relationship with the institution warranted inclusion.

One would think that the above criteria would be adequate to determine when to include or exclude an entity. That wasn't the case however – especially in situations involving organizations that support public colleges and universities. The fund-raising and other entities supporting public institutions only occasionally fit the criteria for establishing an entity as a component unit under Statement No. 14. Most organizations associated with public colleges and universities are legally separate. Many institutions do not appoint a voting majority of the organization's board, and of those that do, most cannot "impose their will" on the organization as defined in Statement No. 14. Most affiliated organizations are "fiscally independent" in that they can establish budgets and issue debt without the institution's approval. Additionally, they do not have a "financial benefit or burden relationship" with the institution because the institution cannot access the organization's resources unless it dissolves. Furthermore, the institution is not legally obligated to provide financial support to the organization in any form. These conditions led most public colleges and universities to the conclusion that they could either disclose the affiliated organization in the footnotes as a "related organization," or apply professional judgment as to whether the organization was excluded entirely from the financial reports.

The existence of so many affiliated organizations that did not meet the criteria for classification as component units, but which might be defined as being "closely related" necessitated the additional research called for in paragraph 41. It also explains why the practice among colleges and universities for reporting affiliated organization financial activity has been so diverse since the issuance of Statement No. 14. Some colleges and universities elected to present affiliated organizations through blending. Others have chosen discrete display to present their affiliated organizations. The vast majority of colleges and universities, however, did neither. A few elected to describe the affiliated organizations in their notes – even though this was an option under Statement No. 14 only for related organizations, for which the institution appoints a voting majority of the governing board, but is not financially accountable. The remainder have done nothing, awaiting the outcome of the additional study mentioned in paragraph 41.

Several representatives of public colleges and universities served on a task force established to guide the research referenced in paragraph 41. The process did not provide for much input from these representatives. The task force process culminated in 1994 with the issuance of a poorly received exposure draft (ED). The college and university representatives on the task force submitted comment letters opposing the proposed standard. The proposal was most notably criticized for the lack of any guidance on materiality. The result was an outcry from some quarters, especially public elementary and secondary education. As proposed, the standard in the ED would have applied to many parent-teacher organizations, booster clubs, and similar small entities supporting local school districts. It would have had a similar negative effect on public colleges and universities, many of which also provided comments opposing the ED.

The project remained on hold for several years while GASB worked on the new reporting model that was finalized and released through Statement Nos. 34 and 35 in 1999. Work on the affiliated organizations project resumed shortly thereafter. The information received in response to the earlier ED was analyzed in preparation for the issuance of a new standard. No task force was assembled but there was a good deal of informal dialogue between GASB and various groups, including NACUBO.

GASB identified three alternatives to address the inclusion of affiliated organizations: note disclosure, a single line item display, or discrete columnar display. NACUBO preferred note disclosure if the affiliated organizations were required to be addressed at all. In this approach, a footnote would describe the entity and its activities and be accompanied by highly condensed financial statements. The line item approach would have resulted in the net assets of the affiliated organization being presented on the balance sheet of the college or university using a caption of "resources held by others." As discussed earlier, discrete display requires that the

financial statements of the affiliated organization appear side-by-side with those of the college or university.

### THE NEW STANDARD

GASB Statement No. 39 will be effective for the periods beginning after June 15, 2003. The goal of GASB 39 is to eliminate inconsistencies in the application of what is included in the reporting entity by clarifying what is a component unit and as a consequence clarify what should be included in the reporting entity. This clarification amends treatment of affiliated organizations that had not otherwise been classified as component units under GASB 14.

GASB 39 adds a paragraph to GASB 14, which states:

40a. Certain organizations warrant inclusion as part of the financial reporting entity because of the nature and significance of their relationship with the primary government, including their ongoing financial support of the primary government or its other component units. A legally separate, tax-exempt organization should be reported as a component unit of a reporting entity if *all* of the following criteria are met:

1. The economic resources received or held by the separate organization are entirely or almost entirely for the direct benefit of the primary government, its component units, or its constituents.
2. The primary government or its component units is entitled to, or has the ability to otherwise access,<sup>a</sup> a majority of the economic resources received or held by the separate organization.
3. The economic resources received or held by an *individual organization* that the specific primary government is entitled to, or has the ability to otherwise access, are significant to that primary government.

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<sup>a</sup>The ability of a primary government to *otherwise access* the resources of an organization does not necessarily imply *control* over that organization or its resources; rather, it entails a broader concept. As noted in paragraph 29 of Statement 14, the *ability to access* the resources of an organization – not necessarily whether there was an actual transaction during the period – is the important factor for determining when a primary government is entitled to an organization's resources. A primary government's *ability to otherwise access* may be demonstrated in several ways. For example, the primary government or its component units historically may have received, directly or indirectly, a majority of the economic resources provided by the organization, the organization previously may have received and honored requests to provide resources to the primary government, or the organization is a *financially interrelated* organization, as defined by FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*.

Paragraph 41 of Statement 14 is replaced by the following:

41. In addition, other organizations should be evaluated as potential component units if they are closely related to, or financially integrated<sup>b</sup> with, the primary government. It is a matter of professional judgment to determine whether the nature and the significance of a potential component unit's relationship with the primary government warrant inclusion in the reporting entity.

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<sup>b</sup>Financial integration may be exhibited and documented through the policies, practices, or organizational documents of either the primary government or the organization being evaluated as a potential component unit.

Component units that meet the above criteria will require discrete presentation. This means a separate columnar presentation for each component unit identified on the face of the institution's financial report. GASB 14, paragraph 51, also provides institutions with multiple component units the ability to consolidate these into one column on the face of the financial statements and then provide the detail on each component unit in the notes. Language in GASB 14, paragraph 53, still provides criteria for component units that are so intertwined with the primary government that they must be reported through a blended presentation.

Two GASB members issued dissenting positions to the statement. Edward M. Klasny and Paul R. Reilly both agreed with the additional criteria established in the standard. Their disagreement was with the reporting requirement for discrete display. They preferred disclosure in the notes. These board members were obviously more receptive to the arguments made not only by NACUBO and the NACUBO Accounting Principles Council (APC), but also by the majority of the respondents to the ED.

### **THE PROCESS AND THE APC'S ROLE IN IT**

The APC has worked with GASB on this issue since the early 1990s when revisions to GASB 14 were first discussed. The APC's working relationship with GASB dates to GASB's creation. The APC has used both the formal process allowed by the GASB through the exposure draft and comment process, and informal mechanisms established by the APC for more direct interaction with the GASB.

When GASB discussed the affiliated organization issue at its September 2000 meeting, NACUBO sent the chair of the Accounting Principles Council to observe, discuss the issues with the board informally during breaks, and report back to NACUBO and the APC on the nuances of the discussions. The meeting provided insights about GASB's intent in revisiting GASB 14. The board felt that higher education was not fully disclosing the resources available to them and that compliance with GASB 14 was not consistent across the industry.

In February 2001, the APC met with GASB representatives in its Norwalk, Connecticut headquarters, where a number of issues were covered, including a detailed discussion on affiliated organizations. A major thrust of the APC's appeal to the GASB was support for note disclosure as the most appropriate means for presenting financial information about affiliated organizations. Various arguments were offered, including concerns about the possible consequences if affiliated organizations' resources were presented on the face of the institution's financial statement. APC members spoke about possible reductions of future contributions, attempts on the part of state government to claim a portion of the net assets held by affiliated organizations during budgetary crises, and reductions in state appropriations due to the misperception that the affiliated organization's resources are controlled by the college or university.

With the release of the revised exposure draft in July 2001, it became clear to NACUBO and the APC that the discussions in Norwalk had not deterred GASB from establishing most public colleges and universities' affiliated organizations as component units. This would automatically result in the discrete presentation of the affiliated organizations' financial data on the face of the public institution's financial statements. The APC solicited feedback on current practices by releasing a survey. The plan was to utilize the data gathered in NACUBO's official response to the ED. A total of 46 colleges and universities responded. The summary results of the survey are:

- All respondents had affiliated organizations, ranging from one to 26, with an average of 5.6 each.

- ❑ Of the 46 institutions that had affiliated organization, 17 did not disclose, seven blended, 25 reported in the footnotes at varying levels of detail, and six discretely presented. Some institutions treated different affiliated organizations in differing ways.
- ❑ Most colleges and universities indicated that the impact of implementation of the proposed GASB standards would be adverse and not add value to the financial statements of the institution.

Although NACUBO determined that the data gathered through the survey would not add analytically to the arguments presented by the association in its official response to the ED, the information and comments generated provided NACUBO with insight on how to structure and prioritize the arguments laid out in the contents of its response.

For important issues such as this one, GASB's process includes public hearings to allow individuals and organizations to present their position on exposure drafts. Present and former members of NACUBO's APC testified at these hearings, with Larry Goldstein presenting the formal NACUBO position. GASB allowed NACUBO and the APC to submit one final position paper in late February 2002, in which arguments were made for note disclosure. This paper was a detailed follow-up to the testimony presented by NACUBO at the public hearings. The APC believes GASB's willingness to accept additional input is indicative of the importance the board places on the data gathering process. However, it had little effect on the final standard.

#### **APC ARGUMENTS PRESENTED**

The cost of public higher education has escalated dramatically in the last 20 years. With pressure mounting from citizen groups, state legislatures have become much more proactive in controlling increases in tuition charged by public colleges and universities. Increasingly, public institutions must now look to sponsored programs and private donors for supplemental funding of their core missions. As a result, the importance of private foundations that exist to support public colleges and universities is becoming more evident, and the resources they hold to assist higher education institutions are growing. Thus, the APC agreed with GASB's concern that information about these resources should be provided in the financial reports of public colleges and universities. However, the APC strongly disagreed with the conclusion in the exposure draft that the discrete presentation was the appropriate and most effective reporting approach.

**Control of Assets.** The discrete approach requires presentation of the assets, liabilities, revenues, and expenses of the private support organizations in separate columns on the face of the financial statements of public colleges and universities. (Alternatively, these same data for the affiliated organizations may be included on separate statements immediately following the financial statements of the public institution.) The APC believed this would create the false impression that the public institutions controlled the assets of the support organizations. Rather than GASB enhancing financial statements by clarifying the appropriate "misleading to exclude" criteria, this change might dangerously mislead financial statement users. A financial statement user could conclude that public colleges and universities had actual discretionary control over the assets and other resources of the affiliated organizations reported in the statements, which in most cases is untrue.

Many of the private foundations that support public colleges and universities today are independent of the actual institutions on whose behalf they solicit private funds. The boards of such private foundations commonly comprise powerful, successful business people who tightly control the policies and budgets of these fund raising organizations. These individuals in many cases are not selected or appointed by the public institutions that the affiliated organizations support. Many such foundations establish their own priorities for the use of their resources, which are typically used, not to support the core operations of the university, but for the programs and activities that the foundations and their donors consider high priorities. Thus, most public colleges and universities with private foundations are unable to exercise control over these organizations and do not have discretionary control of the assets and resources.

Without question, public colleges and universities will receive future economic benefits from their private foundations. However, when considering how to most appropriately disclose this information in the financial statements, the APC believed it most critical to ensure that the readers of the statements not be given the false impression that the public institution has discretionary control over the assets and resources of its private foundations.

**Legislative Oversight and Donor Concerns.** Public colleges and universities face many social and political realities in the daily challenge to manage their institutions effectively. State legislators may not fully understand these challenges. They might misinterpret financial statements and incorrectly assume that colleges and universities control the future resources to be provided by affiliated organizations. This could result in direct and indirect reductions in state appropriations made to higher education.

Reporting affiliated organizations discretely could have a direct effect on donors. Many private individuals and organizations that support higher education wish to remain anonymous. They question the likelihood of maintaining confidentiality with organizations so closely affiliated with public institutions. These individuals demand effective use of their donations and might redirect their contributions to private colleges and universities if it appears that the private foundations of public institutions are being publicly controlled or are subject to public audit. In this environment, the APC believed it was especially critical that changes made to the financial statements of public colleges and universities not create misleading perceptions about accessibility of the funds by state governments.

**Inconsistencies Between GASB and FASB.** Public colleges and universities are subject to the accounting and financial reporting standards issued by GASB. However, most affiliated organizations must follow the standards promulgated by FASB. The APC believed that if the discrete approach was adopted, many public institutions with affiliated organizations would experience substantial and expensive technical difficulties converting the statements of their support organizations to the GASB format required for public institutions. Although GASB had indicated in paragraph 31 of the ED that such difficulties might be eliminated by including the statements of affiliated organizations on separate pages in the public institution's financial report, rather than in separate columns on the public institution's financial statements, the APC believed this option could create confusion and clutter the report. This mixing of "apples and oranges" might make the financial reports confusing and potentially more misleading to the users of the statements; there are significant differences between the underlying FASB and GASB accounting requirements.

**Timing and Cost of Audits.** Independent public accountants perform the annual audits of most affiliated organizations of public colleges and universities. In many cases, such audits are scheduled after the audit "busy" season, to minimize the cost to the affiliated organizations. As a result, the affiliated organization audit reports typically become available after the deadline has passed for the submission of the public institution's fiscal year-end financial statements to the related state oversight agency. In order to provide a reasonable timeframe within which to comply with such state deadlines, affiliated organizations might need to change their fiscal year-end dates and/or their audit timetables. The APC believed this could result in an increased expense to both the affiliated organization and the public institution in meeting the deadlines for completing a combined financial statement. GASB believes paragraph 59 in Statement 14 addresses this issue by allowing an institution to include affiliated organization financial statements that are up to 11 months old. The APC believed the use of this less timely data only further compromised the usefulness of the combined reporting format.

**NACUBO Recommended Alternatives.** After reviewing the other options considered by GASB relative to how additional information about resources of affiliated private foundations might best be provided in the financial reports of public colleges and universities, NACUBO supported the alternative views presented in the ED. NACUBO and the APC concurred with concerns expressed in paragraph 34 that the discrete presentation would confuse financial statement users, and that such users might inappropriately conclude that public colleges and universities had

greater control over affiliates and their resources than they actually do. NACUBO also agreed with the views presented in paragraph 35 that affiliated organizations were significantly different from other component units, and that different reporting approaches were appropriate as a result of such differences. In addition, NACUBO believed that financial statement users would be best served if the financial information of affiliated organizations were reported in a manner that distinguished them from other component units, and that requiring the discrete presentation for both types of entities would seriously cloud this critical distinction.

NACUBO supported note disclosure of summarized financial data for affiliated organizations as an appropriate alternative to discrete presentation. NACUBO believed there was no basis for inclusion of the individual assets and liabilities of affiliated organizations in the financial statements of public institutions, and that presenting in the footnotes summarized financial data that highlighted the net financial resources expected to benefit public colleges and universities would satisfy the needs of financial statement users for information about affiliated organizations supporting such public institutions. This argument is similar to GASB reasoning for the presentation of related organizations.

NACUBO also supported the line-item presentation of “net assets” as a possible alternative for including financial data related to the resources of affiliated organizations in the financial statements of public institutions. The association determined that the reporting of “resources held by others” in the financial statements would be an acceptable alternative and might appropriately disclose the future economic benefits to be received.

## **SUMMARY**

The opponents of discrete display were fighting an uphill battle. The ED that preceded Statement No. 14 in the early 1990s included provisions that would have allowed the financial information for some entities to be presented through note disclosure. The written responses to GASB on this proposal were overwhelmingly negative and the note disclosure provision was removed from the final standard before Statement No. 14 was issued. Many have pointed out that circumstances are different today than in 1991 and, since Statement No. 14 is being amended, it is reasonable to reconsider the use of note disclosure. GASB has decided that consideration of a change of this magnitude must wait until Statement No. 14 undergoes a complete review – something that will not occur for several years.

NACUBO’s and the APC’s work on this issue continues. The association will provide guidance to members on implementation of Statement 39 and will continue to advise GASB to revisit this issue when it revisits Statement No. 14.

## **About the Authors**

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