October 13, 2015

Mr. David Bean
Director of Research and Technical Activities
Governmental Accounting Standards Board
401 Merritt 7, P.O. Box 5116
Norwalk, Connecticut 06856-5116

RE: Project No. 3-28E

Dear Mr. Bean:

PricewaterhouseCoopers LLP (PwC) appreciates the opportunity to comment on the Governmental Accounting Standards Board’s (the Board’s) June 22, 2015 Exposure Draft, Blending Requirements for Certain Component Units (the proposal). Our client base that employs GASB standards consists primarily of governmental businesses, including state universities and healthcare systems, that make frequent use of legally separate component units structured as corporations, partnerships, and LLCs. Over the years, we have had many discussions with the GASB staff regarding the blending requirements, and we commend the Board for taking on a project to provide much-needed guidance in this area.

Membership not-for-profit organizations

Under state corporation laws, not-for-profit organizations (NPOs) can be formed with or without a membership structure. Used in this context, “membership” and “members” refer to parties that possess legal rights pertaining to the governance of an NPO that are similar to those of shareholders in a business entity. In some states, NPOs are presumed to have a membership structure unless the articles of incorporation state otherwise; in others, the articles of incorporation must affirmatively state whether or not the NPO has members.

We support the Board’s decision to establish a fourth blending requirement to address situations where the government is the sole corporate member of an NPO used in carrying out the government’s activities. In this type of NPO, the sole corporate member wields absolute power over the entity’s activities. We agree that in these circumstances, a blended presentation provides the best representation of the reporting entity.

Because the concepts and terminology used in reference to not-for-profit corporations may not be familiar to some, we recommend that the guidance incorporate definitions of key terms (for example, “sole corporate member” and “membership”).

Non-member NPOs

If an NPO does not have a membership structure, all decisions rest with the board of directors. If the directors wish to cede legal control to another organization as the result of, for example, a business combination, the articles of incorporation and bylaws would be amended to give the acquirer the right to appoint a majority of the NPO’s governing board. The acquirer would normally possess rights and powers over corporate decisions that are substantively equivalent to those of a sole corporate member (unless the articles or bylaws explicitly impose limitations, such as “reserve powers” granted to another entity).
example, the acquirer can usually unilaterally control the outcome of all board votes, including those related to amendments to the NPO’s articles or bylaws, and decisions on fundamental corporate transaction, such as mergers, sales of substantially all assets, or dissolution.

In the interest of comparability of reporting, we suggest the Board also permit the blending of non-membership NPO component units where the government’s rights are substantively equivalent to those of a sole corporate member. Otherwise, we believe that some governments will employ a “substance over form” approach to the blending analysis while others will not, resulting in diversity in practice.

**Statement 39 component units**

According to paragraph 2, the proposal does not apply to NPOs that are determined to be component units under the “misleading to exclude” provisions of Statement No. 39, *Determining Whether Certain Organizations Are Component Units*. It may be helpful to clarify that in the situations contemplated by the proposed standard, an NPO would be considered a component unit under the “financial accountability” provisions of Statement No. 14, *The Financial Reporting Entity* (rather than Statement No. 39’s “misleading to include” considerations). A governmental sole corporate member (or its equivalent in a non-membership NPO) would be financially accountable for the NPO because it has the power to select the directors and otherwise impose its will on the organization. Statement No. 14’s “financial accountability” provisions and Statement No. 39’s “misleading to exclude” provisions are mutually exclusive; thus, if a government is financially accountable, Statement No. 39 would not apply.

The proposed codification language in paragraph D1 states that blending is required if “[t]he component unit is organized as a not-for-profit corporation in which the primary government is the sole corporate member, unless the component unit is included in the reporting entity pursuant to the requirements of paragraph .140 of Section 2100” [emphasis added]. We suggest removing the italicized phrase. As indicated previously, if a government appoints a voting majority of the component unit’s board, Statement No. 39’s “misleading to exclude” criteria (Section 2100.140) would not apply.

It may also be helpful to clarify that under the jurisdictional arrangement agreed to by the GASB and FASB (specifically, the “Definition of a Government” used in the AICPA audit and accounting guides *Not-for-Profit Entities, Health Care Entities, and State and Local Governments*), the use of GASB standards is required if state or local government officials appoint or approve a controlling majority of the members of a private sector organization’s governing body. Thus, unlike many NPOs that are deemed to be component units under Statement No. 39, the NPOs affected by this proposal would prepare their financial statements in accordance with GASB standards.

**Majority-owned component units**

We encourage the Board to reconsider providing a blending criterion for situations in which the government has a majority voting interest in for-profit component units that provide or carry out governmental services.

Paragraph B8 indicates that the Board considered, but decided against, providing an explicit blending criterion for for-profit component units that are less-than-wholly owned. The proposal makes no mention of the considerations for wholly-owned component units (although single-member LLCs would
presumably be addressed as described in paragraph B7). If a government is the sole shareholder of a
corporate component unit that provides services to the government’s constituency (rather than to the
government itself)—for example, a wholly-owned for-profit Health Maintenance Organization (HMO)—
the component unit could not be blended for the same reasons described in paragraph B5 for NPOs. In
both cases, the relationship between the primary government and the component unit is established
through articles of incorporation and bylaws, rather than through traditional component unit
relationships. The proposed guidance would amend the blending criteria to allow NPOs with a sole
corporate member to be blended; it would appear that blending of wholly-owned for-profit component
units that carry out a similar function is also justifiable. In fact, we believe blending would be appropriate
for any situations where the government has a majority voting interest in a for-profit component unit.

**Limited liability companies (LLCs)**

LLCs are becoming the “vehicle of choice” for tax-exempt entities seeking to expand or reorganize their
services because LLCs can carry out activities on behalf of a tax-exempt parent without the need for a
separate IRS tax-exemption determination.

Paragraph B7 observes that “LLC component units generally do not have separate governing boards” and
thus, the Board believes that “blending those component units would be consistent with existing financial
reporting standards in certain circumstances.” It is not clear whether the phrase *those component units*
refers to all LLCs, or only to the subset of LLCs that do not have governing boards.

If the intent is the former, we do not believe that LLCs should be viewed as a single class of entities. This is
due to the inherent flexibility of LLC structures. In single-member LLCs, typically the LLC’s activities are
viewed as if they were conducted directly by the sole member. Some multi-member LLCs function like LPs
or LLPs (and do not have governing boards, as noted by the Board), while others are used to form tax-
exempt joint ventures that may be governed by separate boards of directors. We encourage the Board to
consider these differences.

Paragraph B7 also states that “[t]he Board will consider providing clarifying guidance addressing this
situation in the form of one or more questions and answers in a future Implementation Guide.” We
encourage the Board to promulgate all changes and clarifications to the blending guidance—those in this
proposal and those that are contemplated for LLCs—in a manner that will allow them to be adopted
contemporaneously. Retroactive application of all changes impacting blending decisions at one time would
be preferable to adopting the currently proposed guidance related to NPO component units, and then
needing to retroactively restate again a year later to blend certain LLCs.

**Effective date**

We support the Board’s decision to encourage early adoption of this statement, and support the proposed
effective date. However, please see our comments in the previous section related to the timing of clarifying
guidance for LLCs.
**Other related matters**

Neither Statement No. 14 nor Statement No. 61, *The Financial Reporting Entity: Omnibus*, explicitly addresses LPs, LLPs, or LLCs. As a result, governments must exercise judgment when evaluating these types of entities for inclusion as component units. This can be particularly challenging in situations where a general partner (or managing member) controls the day-to-day operations, but one or more limited partners hold the majority of the equity interests.

Certain Q&As in Implementation Guide 2015-1 provide relevant guidance. According to Question 4.17.1, a primary government is financially accountable for a legally-separate organization used in providing governmental services (and thus, should report it as a component unit) if it owns a majority of the equity interest in the entity. However, Question 4.18.11 indicates that an LP’s general partner with authority over day-to-day operations should report the LP as a component unit.

The guidance in Question 4.17.1 would appear to be helpful in situations where participants’ voting powers correspond to the level of equity interest held, but that is not often the case in an LP. We suggest that the Board consider whether Question 4.17.1 should be modified to avoid a conflict with the concepts described in Question 4.18.11. We also suggest that Question 4.18.11 be clarified to indicate that the LP in that example does not have an actual governing board.

Finally, we suggest that the *de facto* criterion for financial accountability in Question 4.17.1 be explicitly incorporated into Statement No. 14 and Codification Section 2100, *Reporting Entity and Component Unit Presentation and Disclosure*. When evaluating financial accountability, preparers and auditors look to the guidance in paragraph 21 of Statement No. 14 and the related flow chart in Appendix C. Question 4.17.1 cites paragraph 55 of Statement No. 14 as the source of the additional criterion. Paragraph 55, which discusses evaluating the intent for holding a for-profit investment, would not normally be considered and contains no reference to “financial accountability.” To give the *de facto* third criterion greater visibility, we suggest it be added to Statement 14 in (1) paragraph 21(a) by direct inclusion or in a footnote and (2) the flowchart in Appendix C.

*   *   *   *   *

We appreciate the opportunity to share our thoughts on the proposal. If you have any questions regarding our comments, please contact Patrick Durbin at (973) 236-5152 or Martha Garner at (973) 236-7294.

Very truly yours,

PricewaterhouseCoopers LLP