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Governmental Accounting Standards Series

Statement No. 39 of the
Governmental Accounting
Standards Board

**Determining Whether
Certain Organizations Are
Component Units**

an amendment of GASB Statement No. 14

GASB

Governmental Accounting Standards Board
of the Financial Accounting Foundation

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This Statement is dedicated

to the memory of

Statement 39 project manager

Joseph C. Blythe

1941–2002

Summary

An objective of Statement No. 14, *The Financial Reporting Entity,* is that all entities associated with a primary government are potential component units and should be evaluated for inclusion in the financial reporting entity. This Statement amends Statement 14 to provide additional guidance to determine whether certain organizations for which the primary government is not financially accountable should be reported as component units based on the nature and significance of their relationship with the primary government. Generally, it requires reporting, as a component unit, an organization that raises and holds economic resources for the direct benefit of a governmental unit.

Organizations that are legally separate, tax-exempt entities and that meet *all* of the following criteria should be discretely presented as component units. These criteria are:

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, 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, or its component units, is entitled to, or has the ability to otherwise access, are significant to that primary government.

This Statement continues the requirement in Statement 14 to apply professional judgment in determining whether the relationship between a primary government and other organizations for which the primary government is not financially accountable and that do not meet these criteria is such that exclusion of the organization would render the financial statements of the reporting entity misleading or incomplete. Those component units should be reported based on the existing blending and discrete presentation display requirements of Statement 14.

The provisions of this Statement are effective for financial statements for periods beginning after June 15, 2003. Earlier application is encouraged.

Unless otherwise specified, pronouncements of the GASB apply to financial reports of all state and local governmental entities, including general purpose governments, public benefit corporations and authorities, public employee retirement systems, and public utilities, hospitals and other healthcare providers, and colleges and universities. Paragraph 3 discusses the applicability of this Statement.

Statement No. 39 of the
Governmental Accounting
Standards Board

Determining Whether Certain Organizations Are Component Units

an amendment of GASB Statement No. 14

May 2002

Governmental Accounting Standards Board
of the Financial Accounting Foundation
401 Merritt 7, P.O. Box 5116, Norwalk, Connecticut 06856-5116

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Determining Whether Certain Organizations Are Component Units

an amendment of GASB Statement No. 14

May 2002

CONTENTS

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INTRODUCTION

1. The objective of this Statement is to provide criteria for determining whether certain organizations should be reported as component units based on the nature and significance of their relationship with a primary government and to clarify reporting requirements for those organizations.

2. Statement No. 14, *The Financial Reporting Entity,* establishes standards for defining and reporting on the financial reporting entity. Paragraph 12 of that Statement provides that the financial reporting entity consists of (a) the primary government, (b) organizations for which the primary government is financially accountable, and (c) other organizations for which the nature and significance of their relationship with the primary government are such that exclusion would cause the reporting entity's financial statements to be misleading or incomplete ("misleading to exclude"). Although paragraph 41 of Statement 14 notes that "other organizations should be evaluated as potential component units if they are closely related to the primary government," it also indicates that "the GASB is studying circumstances under which foundations [and] similarly affiliated organizations . . . might be included in the financial reporting entity." Inconsistencies in application of the reporting entity standards have occurred in practice because of uncertainties regarding these circumstances.

STANDARDS OF GOVERNMENTAL ACCOUNTING AND FINANCIAL REPORTING

Scope and Applicability of This Statement

3. This Statement establishes additional guidance on the application of existing standards for the assessment of potential component units in determining the financial reporting entity. It applies to financial reporting by primary governments and other stand-alone governments, and to the separately issued financial statements of governmental component units as defined in paragraph 9 of Statement 14. In addition, this Statement should be applied to nongovernmental component units when they are included in a governmental financial reporting entity.

4. This Statement adds paragraph 40a to Statement 14 and amends paragraphs 41 and 42 of that Statement.

Clarification of Provisions to Include Organizations in the Reporting Entity

5. Paragraph 40a is added between paragraphs 40 and 41 as follows:

> 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,[a] 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, or its component units, is entitled to, or has the ability to otherwise access, are significant to that primary government.

[a]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.*

6. 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[b] 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.

[b]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.

Reporting Component Units

7. Component units that meet the criteria in paragraph 40a should be discretely presented. Additional requirements and alternatives for reporting discretely presented component units are provided in paragraphs 44 through 51 of Statement 14, as amended. Paragraph 42 is replaced by the following:

42. Financial statements of the reporting entity should provide an overview of the entity, yet allow users to distinguish between the primary government and its component units. Because of the closeness of their relationships with the primary government, component units that meet the criteria in paragraph 53 should be blended

as though they are part of the primary government. However, most component units, including those that meet the criteria of paragraph 40a, should be discretely presented.

8. Organizations that are determined to be component units based on the provisions of paragraph 41 should be blended or discretely presented as required by paragraphs 44 through 54 of Statement 14, as amended.

EFFECTIVE DATE AND TRANSITION

9. The provisions of this Statement are effective for financial statements for periods beginning after June 15, 2003. Earlier application is encouraged. Adjustments resulting from a change to comply with this Statement should be treated as adjustments of prior periods. The financial statements of all prior periods presented should be restated, if practical, to show the financial information of the new reporting entity for all periods. If restatement of the financial statements for prior periods is not practical, the cumulative effect of applying this Statement should be reported as a restatement of beginning net assets/fund balance for the earliest period restated. In the period this Statement is first applied, the financial statements should disclose the nature of the restatement and its effect.

The provisions of this Statement

need not be applied to immaterial items.

This Statement was adopted by the affirmative vote of five members of the Governmental Accounting Standards Board. Messrs. Klasny and Reilly dissented.

Messrs. Klasny and Reilly dissent to this Statement because they object to the requirement to discretely display certain organizations as component units of a reporting entity. Although they agree that the criteria in this Statement are appropriate, they believe that meeting those criteria should not cause an organization to be regarded as a component unit. They also believe that most of the organizations that meet the criteria in this Statement have unique and significantly different characteristics from most component units as defined by Statement 14. These differences are:

a. They generally are not created or organized by the primary government.
b. They generally do not provide services to the public.
c. Their activities are usually restricted to providing financial resources to the government.

Messrs. Klasny and Reilly therefore believe that these characteristics justify a different classification for those organizations and a different approach—disclosure in the notes—for reporting their financial information. They believe that discrete presentation, which stems from the classification as component units, will be misleading and confusing to readers because of the direct implication that the primary government is accountable for, or has ownership of, the financial and capital resources of these organizations.

Although the requirement to discretely present financial information for these organizations is based on a "misleading to exclude" concept, Messrs. Klasny and Reilly believe that it is *misleading to include* these organizations by display. The belief that it is misleading to include by display appears to be supported by research that indicates that readers of financial statements generally place greater significance on financial information that is displayed than on the same information disclosed in notes. In addition, paragraph 42 of Statement 14, before it was amended by this Statement, stated that "financial statements of the reporting entity should provide an overview of the entity based on *financial accountability*" (emphasis added). They believe, therefore, that it is highly likely that readers will presume that the primary government is accountable for all financial and capital resources displayed.

Messrs. Klasny and Reilly also believe that display of these organizations as discretely presented component units violates, and is in conflict with, the basic principle of accountability, which is referred to in Concepts Statement No. 1, *Objectives of Financial Reporting,* as the cornerstone of all financial reporting in government. They believe that principle would imply that organizations should be accountable for all resources under their control; likewise, they should not be accountable for resources they do not control. A similar concern was stated by the two Board members who dissented to the issuance of Statement 14 and expressed a belief that "the reporting entity definition will result in the inclusion of certain component units that are not in substance part of the primary government." Messrs. Klasny and Reilly believe that this Statement will exacerbate that concern.

Messrs. Klasny and Reilly are also concerned about the "double counting" that will result from discrete presentation. For example, a fund-raising organization that meets the criteria of this Statement will have all of its operating revenues and expenses discretely presented. Any amounts distributed to the primary government will again be reported as revenue in its operating statement. In order to eliminate the double reporting, the preparer would display a total reporting entity column and make the necessary adjustments or eliminating entries. They believe that this additional column and the adjustments will clutter the financial statement.

Messrs. Klasny and Reilly further believe that most governments will display their component units (those that meet the criteria in this Statement as well as existing component units) in the aggregate; therefore, no meaningful information will be presented on the face of the financial statements. In addition, the detail displayed for each organization in the combining statements or notes will be in the same format as for other component units even though the economic substance and financial focus for those organizations is probably unique and significantly different.

Messrs. Klasny and Reilly also point out that respondents to the Exposure Draft of this Statement and those who testified at the public hearings overwhelmingly rejected discrete display for the relevant organizations. A large majority supported only note disclosure as the most appropriate method of presentation.

Mr. Reilly is also concerned by the precedent this Statement will establish by requiring financial information of nongovernmental entities to be included on the face of governmental financial statements. He recognizes that there may be rare circumstances where the relationship between an organization and a primary government is such as to warrant inclusion. Statement 14 provides the ability to do so by exercising professional judgment. This Statement requires discrete presentation of all organizations that meet the criteria contained in this Statement. The application of professional judgment to ensure that readers are not misled will no longer be permissible in many situations. Furthermore, he believes that although it is true that the Board has no evidence that readers have been misled or misinformed in those rare instances where nongovernmental organizations have been discretely presented, it is also true that the Board has no scientifically supported evidence that readers *have not* been misled or misinformed.

Messrs. Klasny and Reilly believe that financial information about the organizations covered in this Statement can best be provided by note disclosure. Because the type and amount of essential information for these organizations is different than for governmental component units, separate disclosure would afford the opportunity to present such information in a manner different from the prescribed format contained in Statement 34. It would also allow readers to distinguish organizations for which the primary government has financial accountability from those that provide financial resources to the government. Finally, Messrs. Klasny and Reilly believe that reporting these organizations differently from component units would be an opportunity to focus on the meaningful relevant information of these organizations and at the same time would eliminate both the practical and conceptual problems as well as the potential misunderstanding associated with discrete presentation.

Members of the Governmental Accounting Standards Board:

Tom L. Allen, *Chairman*
Cynthia B. Green
William W. Holder
Edward M. Klasny
Edward J. Mazur
Paul R. Reilly
Richard C. Tracy

Appendix A

BACKGROUND INFORMATION

10. Statement 14 identifies two categories of component units that, together with a primary government, constitute a financial reporting entity. The first category consists of organizations for which the primary government is financially accountable. As outlined in Statement 14, a primary government’s financial accountability for a legally separate organization is established if the primary government appoints a voting majority of the organization’s governing board and (a) the primary government is able to impose its will on that organization or (b) the organization provides a specific financial benefit to, or imposes a specific financial burden on, the primary government. The Board also recognizes in Statement 14 that a primary government may be financially accountable for organizations that are fiscally dependent on the primary government, regardless of the primary government’s association with the organization’s governing body. The second category of component units consists of organizations for which a primary government is not financially accountable; however, the nature and significance of their relationship with the primary government are such that exclusion would cause the reporting entity’s financial statements to be misleading or incomplete.

11. Those separate organizations in the second category are not always subject to the government's organizational or procedural oversight as described in paragraphs 21 through 37 of Statement 14. Recognizing that establishing specific standards for including those organizations in the reporting entity would have delayed the issuance of the Statement, the Board decided to issue Statement 14 to provide timely guidance on the

more pervasive financial reporting entity issues, and also to include a statement that additional research was being conducted and that pronouncements relating to these organizations would be issued at a later date.

12. The Board established a separate "affiliated organizations" project on its technical agenda in July 1990. The initial research was conducted in cooperation with the National Association of College and University Business Officers (NACUBO). The GASB surveyed NACUBO members on the relationships that existed between their institutions and fund-raising foundations, athletic associations, alumni associations, and research foundations. Initially, it was believed that most organizations included within the scope of the project consisted of fund-raising foundations affiliated with public colleges and universities. However, based on the results of due process and later GASB research, the Board determined that the project was broader than colleges and universities, and organizations that could be considered potential component units of other governmental entities were identified. A twelve-member task force provided input on the alternatives originally considered by the Board, resulting in issuance of an Exposure Draft, *The Financial Reporting Entity—Affiliated Organizations,* in December 1994. The Board received 148 responses to the 1994 Exposure Draft which raised several issues and concerns that resulted in additional staff research in 1997. This research consisted of surveys of museums, libraries, parks and recreation districts, school districts, and hospitals to obtain information on the relationships between these primary governments and their closely related organizations, and if and how these organizations were being reported in the financial statements of the primary government. The responses to the 1994 Exposure Draft and the results of these surveys provided the basis for the Board to issue a revised

Exposure Draft, *The Financial Reporting Entity—Affiliated Organizations,* an amendment of GASB Statement No. 14, in July 2001. The Board received 112 responses to the revised ED.

Appendix B

BASIS FOR CONCLUSIONS

13. This appendix discusses factors considered significant by Board members in reaching the conclusions in this Statement. It includes discussion of the alternatives considered and the Board's reasons for accepting some and rejecting others. Individual Board members gave greater weight to some factors than to others.

Why This Standard Improves Financial Reporting

14. State and local governments raise and hold resources in an almost limitless variety of ways and are free to do so within almost any type of organizational arrangement. Consequently, the information available to the financial statement users about those organizations and the resources they raise and hold may vary from entity to entity. However, this diversity produces difficulties for users who are reading governmental financial statements. The Board believes that it is necessary, and in the best interest of governmental financial statement users, to address this variation of arrangements by establishing conventions for reporting on those financial activities. Without standards, it would be virtually impossible for users to compare one jurisdiction to another or perhaps even a single jurisdiction over time.

15. Research conducted by the GASB indicates that governments have been reporting on similar situations in dissimilar ways. Specifically, some closely related organizations are included in the financial statements of some primary governments (and therefore are part of the reporting entity); however, many other organizations with relationships of a similar nature and significance to other primary governments are not included in the

financial statements of those other reporting entities. The Board believes it is beneficial to financial statement users to develop standards that will enhance comparability among those entities in certain cases, even when different organizational arrangements are used for receiving and holding contributed resources.

16. Research conducted by the GASB, and data produced by other organizations regarding endowments and resources contributed to public institutions of higher education, indicate that presently and increasingly, most of these institutions have very little contributed endowments reported in their own financial statements. Instead, most restricted contributions are held in their separate fund-raising institutions. The GASB research also identified similar trends in fund-raising activities for governmental hospitals, libraries, museums, parks, and school districts. The Board believes that more complete and consistent financial reporting will result when these fund-raising institutions and their resources are included in the financial statements of primary government financial reporting entities.

GASB Statement 14

17. The Board's objective in Statement 14 was that all entities associated with a primary government are potential component units and should be evaluated for inclusion in the financial reporting entity. Some organizations that do not meet the financial accountability criteria appeared to qualify as component units under the additional provision in paragraph 20 of Statement 14, which states that ". . . component units can be other organizations for which the nature and significance of their relationship with a primary government are such that exclusion would cause the reporting entity's financial statements to be misleading or incomplete. . . ." Recognizing that more research might be necessary

to determine if the relationships of some entities to a primary government warranted inclusion in the financial reporting entity, the Board indicated in paragraph 41 of that Statement that research would be conducted and guidance would be released at a later date. Paragraph 41 specifically mentioned "organizations affiliated with governmental units, agencies, colleges, universities, hospitals, and other entities." Upon completion of its original research efforts, the Board released an Exposure Draft in December 1994.

The 1994 Exposure Draft

18. Many of the respondents to the 1994 ED were representatives of local school districts. They pointed out that many organizations are formed to serve specific purposes or to support specific extracurricular activities of their school district or individual schools. They expressed concern about the lack of resources available to evaluate those organizations as potential component units.

19. The proposed criteria in the 1994 ED to evaluate an organization as a potential component unit were (a) the organization has separate legal standing, (b) the affiliation with a specific primary government is set forth in the organization's articles of incorporation, and (c) the affiliation with a specific primary government is set forth in the organization's application to the Internal Revenue Service (IRS) for exemption from payment of federal income tax pursuant to Internal Revenue Code (IRC) Section 501(c)(3). These three criteria were meant to identify an organization as a potential component unit. However, for an organization to be reported as a component unit of the financial reporting entity, the primary government would need the ability to *impose its will* on the affiliated organization, or there would need to be the potential for the organization to provide specific *financial benefits* to, or impose specific *financial burdens*

on, the primary government. Several respondents to the 1994 ED argued that the reference to IRC Section 501(c)(3) was so specific that not all organizations expected to be encompassed by this guidance would be organized under this single IRC section. With the 1994 ED's specific criteria for inclusion, similar organizations would be treated differently simply because some had (a) separately incorporated, (b) indicated affiliation with a specific primary government in their articles of incorporation, or (c) sought tax exemption under IRC Section 501(c)(3), whereas other organizations had decided not to pursue separate incorporation or apply for tax-exempt status.

20. The Board determined that the issues raised by respondents to the Exposure Draft relating to the identification of an organization as a potential component unit were generally well founded. In some instances, organizations too far removed from the primary government might be included as component units using those criteria, and in other circumstances, organizations such as those that are tax-exempt under sections of the IRC other than Section 501(c)(3) might inappropriately be excluded. Therefore, in the deliberations leading to the revised ED, the Board reconsidered the identification and reporting requirements proposed in the 1994 ED. While acknowledging the value of the guidance contained therein, the Board decided not to continue the guidance from the 1994 ED, based largely on the responses to that ED. The Board also considered addressing the issue of affiliated organizations as potential component units in a future project to reexamine Statement 14; however, given its priorities, the Board did not believe that an additional delay of this project for several years was warranted.

The Revised Exposure Draft

21. The approach proposed in the 2001 revised ED would have required that certain legally separate, tax-exempt organizations should be included as component units if all the criteria in a three-step evaluation were met. The three criteria in the revised ED focused exclusively on financial relationships rather than on specific features of the organizational structure—the concept that was the foundation of the 1994 ED. The revised ED did not include the definitional criteria from the 1994 ED, but instead clarified the component unit definition to include *any* legally separate, tax-exempt organization whose financial relationship with the primary government met the three proposed criteria. The requirement that an organization first had to meet the definition of an "affiliated organization" was not carried forward to the revised ED.

22. Respondents' comments to the revised ED centered around four issues: (a) the clarification of "the ability to otherwise access" contained in the second criterion, (b) the clarification of "significant" contained in the third criterion, (c) the clarification of "financially integrated" in the amendment to paragraph 41, and (d) the method of display—discrete presentation. The first two issues are discussed in the "criteria" section, below. The third issue is addressed in the "other organizations" section, and the final issue is discussed in the "discrete presentation" section.

Criteria

23. As noted above, Statement 14 provides guidance to identify and include organizations as component units if the elected officials of the primary government are financially accountable for those organizations. In addition, other organizations for which

the nature and significance of their relationship are such that exclusion may cause the reporting entity’s financial statements to be misleading or incomplete should be evaluated as potential component units. Statement 14 adequately described circumstances where financial accountability was present; however, inconsistency in practice arose as a result of applying the “misleading to exclude” provision to those organizations that did not meet the financial accountability criteria. In this Statement, the Board focuses on establishing criteria for determining the circumstances in which it would be “misleading to exclude” certain organizations from the financial reporting entity. With this focus, the Board concluded that an entity should be evaluated as a potential component unit if it is a legally separate, tax-exempt organization whose resources are used principally to provide significant support to the primary government or its component units.

24. The Board retained the legally separate and tax-exempt criteria from the 1994 ED because research indicates that organizations that provide significant resources to a primary government generally are legally separate and tax-exempt. The Board eliminated the specific references to IRC sections and to the organization’s articles of incorporation to address concerns expressed by respondents to the 1994 ED.

25. Because the primary government does not appoint the voting majority of the governing body of the organizations addressed by this standard, the Board believes that there should be stricter requirements for reporting such organizations as component units. The three criteria in this Statement, discussed in detail in paragraphs 26 through 32, were developed from the standpoint that each should be more restrictive than the previous criterion. This means that the substance and significance of the relationship between the organization and the primary government or its component units would be such that the

exclusion of that organization from the reporting entity's financial statements would render those statements misleading or incomplete from the perspective of the financial statement user.

26. *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.* For purposes of applying this criterion, an organization *directly benefits* the primary government, its component units, or its constituents if it obtains, seeks to obtain, or holds and invests resources that will benefit the primary government, its component units, or its constituents. Direct benefit is not dependent upon an actual transfer of resources from the organization during the period, but rather upon the notion that the resources obtained or held are required to ultimately be used for the benefit of a specific primary government, its component units, or its constituents. This criterion is intended to *exclude* potential component units that benefit multiple constituent groups, such as federated fund-raising organizations, from consideration as component units. For example, a potential component unit that benefits a primary government, a targeted citizen group, and another organization in a given year may give a majority of revenues derived from fund-raising efforts to the primary government in one year, yet to the targeted citizen group or some other organization in the following year. If an organization has the ability to redirect its resources at its discretion so that they would not be entirely or almost entirely for the direct benefit of the primary government, its component units, or its constituents, it would not be reported as a component unit.

27. *The primary government, or its component units, is entitled to, or has the ability to otherwise access, a majority of the economic resources received or held by the separate*

organization. The Board believes that this criterion will further limit inclusion to organizations such as entity-specific fund-raising foundations. For example, such organizations typically either (a) have a history of providing resources to the primary government or (b) receive and honor requests to provide resources to the primary government. As a result, the Board believes that such conditions demonstrate a close relationship with the primary government.

28. Most of the respondents to the revised ED either disagreed with the definition of, or asked for additional clarification of, “otherwise access.” They do not believe that a historical record of providing resources to the primary government, nor honoring requests for resources from the primary government, is necessarily an indicator of future transactions. They contend that past practices do not provide the primary government with the ability to *access* the organization’s resources.

29. The Board agreed that additional clarification of the term *otherwise access* would be beneficial. In its research, the Board determined that most of these potential component units report under the guidance of the Financial Accounting Standards Board’s (FASB) Statements No. 117, *Financial Statements of Not-for-Profit Organizations,* and No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others.* Based on other responses and further discussion, the Board concluded that, in addition to the other examples provided in footnote a to paragraph 40a(2), organizations that are deemed to be “financially interrelated,” as defined by paragraph 13 in FASB Statement 136, should be component units if they meet the other two criteria contained in this Statement. The Board believes that a “financially interrelated” organization implies a relationship with the primary government that would

render the financial reporting entity misleading or incomplete if the financial statements of the "financially interrelated" organization were excluded when the two additional criteria also have been met. It believes this to be particularly true if the potential component unit holds the majority of endowments, gifts, and contributions, whereby the gift or earnings thereon are restricted by donors for the activities of the primary government or its component units. Finally, the Board continues to believe that past actions, such as a history of providing resources to the primary government, or its component units, provide a strong indication that the primary government "has the ability to otherwise access" the economic resources of an organization.

30. *The economic resources received or held by the individual organization that the specific primary government, or its component units, is entitled to, or has the ability to otherwise access, are significant to that primary government.* The purpose of this criterion is to emphasize the *significance,* to the primary government, of the economic resources received or held by an *individual* organization. This constitutes a higher threshold for inclusion than is provided for component units that meet the financial accountability criterion in Statement 14. The criterion is considered by the Board to be a higher threshold because the assessment is based on (a) the entire primary government rather than individual reporting units and (b) individual organizations rather than all organizations of a similar type (for example, parent–teacher associations). Generally, smaller booster clubs and parent–teacher organizations would not meet this criterion and therefore need not be reported as component units.

31. Many respondents requested that the Board further clarify or define the term *significant* in the third criterion. Because of the effects that the term has in GASB

literature, the Board had a general discussion of the term and its appropriate use. The Board decided that in some cases in which it is impracticable to provide more precise guidance, it is appropriate to use terms such as *significant* to provide general guidance to preparers and attestors, while leaving the final determination to professional judgment. Therefore, the Board decided to continue using the term *significant* in the third criterion without further clarification or definition.

32. The Board believes that these criteria provide the necessary guidance to determine whether certain organizations should be reported as component units in the financial reporting entity. The nature of the relationship between the potential component units contemplated by this Statement and their primary governments generally is not as administratively intertwined as those in Statement 14 (for reasons such as the absence of the appointment of the majority of the governing body); therefore, the Board believes that a higher threshold for inclusion is warranted. Thus, in order to cross the higher threshold, a substantial relationship should exist between the primary government and the potential component unit. Although the primary government does not appoint a majority of the component unit's governing body, the Board is not aware of any situation in which an organization that raises significant resources for the primary government was created without either the direct or indirect consent of the primary government.

Other Organizations

33. The Board continues to believe that there may be situations in which organizations that have a significant relationship with the primary government do not meet the specific criteria in Statement 14, as amended. In these circumstances, *professional judgment* is necessary to determine whether exclusion of the potential component unit makes the

primary government's financial statements misleading or incomplete due to the nature and significance of their relationship. This Statement amends paragraph 41 to emphasize that closely related organizations include those that are financially integrated with a primary government and may warrant evaluation for their inclusion in the financial reporting entity.

34. In addition to other factors, financial integration may be exhibited and documented through the wording of charters and bylaws of either the primary government or the potential component unit. For example, these charters and bylaws may contain wording such that failure to distribute the resources to the primary government may cause the organization to lose its tax-exempt status. Other examples of financial integration might include:

a. Participation by employees of a potential component unit in programs sponsored by the primary government
b. Representation in financial aid accountability systems of work-study fellowships granted to students of a primary government for work performed for the potential component unit
c. Participation by employees of the primary government in research activities of the organization and inclusion of that activity in the effort reports of the primary government
d. Provision of office space and administrative services to or from the potential component unit.

Several respondents to the revised ED suggested that the examples included above for "financially integrated" be moved to the Standards section to provide more clarity. The Board continues to believe that the central theme of paragraph 41 is that professional judgment may indicate that other organizations that do not meet other criteria for inclusion contained in Statement 14, as amended, should be included in the financial reporting entity as component units.

Discrete Presentation

35. Discrete presentation provides financial statement users with the most complete display of the component unit's activities without obscuring the financial information of the primary government. The Board's deliberations led it to conclude that the relationships between component units that meet the criteria of this Statement and their primary governments are sufficiently different from similar organizations that meet the blending criteria in Statement 14 to warrant separate reporting guidance. The Board believes that discrete presentation is the most appropriate method of providing comprehensive information to users while distinguishing between the component units' information and that of their primary governments.

36. The comprehensive view of both governmental and nongovernmental component units provided by discrete presentation has been an integral part of financial reporting since the release of NCGA Statement 7, *Financial Reporting for Component Units within the Governmental Reporting Entity*, in 1984. One of the mainstays that originated with NCGA Statement 7 and continues through Statement 14 and this Statement is discrete presentation's ability to present the financial information of both the primary government and the component unit without distorting either. Paragraph 44 of Statement 14 states that discrete presentation entails the display of component unit financial data in one or more columns separate from the financial data of the primary government. An important element of the discrete presentation methodology is the requirement to provide supporting information (about individual major component units) in the basic financial statements. That is, a reporting entity may display any of its major component units, including those that meet the criteria in this Statement, in a separate column. Alternatively, the financial

data of the reporting entity's major component units could be provided in combining statements or in the notes to the entity's financial statements.

37. Statement 14 became effective at the end of 1992 and made discrete presentation of component unit information the primary method of display. Since that time, the Board has not been made aware of any evidence that users have been either misled or confused by financial information provided through discrete presentation, even in the common instances in which the net assets of component units could not be used for the programs of the primary governments. This position was further supported by testimony received at the 2001 public hearings by those governments that currently present their legally separate fund-raising activities as discretely presented component units. Information about organizations that obtain, seek to obtain, or hold or invest resources that will benefit a particular primary government, or its component units, is of particular interest to financial statement users who wish to assess the financial position of the primary government's financial reporting entity. Users are also interested in the effort necessary for the organizations to obtain and invest those resources, and the fund-raising expenses necessary to accomplish this. The Board believes that even though the relationship of these organizations contemplated by this Statement differs somewhat from other component units, those differences do not warrant a completely different approach to the display of these organizations in the reporting entity's financial statements.

Other Reporting Methods Considered

38. During deliberation of this Statement, the Board considered several reporting alternatives that would have either included the organizations as component units within the guidance of Statement 14 or excluded these organizations from the reporting entity

and created a separate category of reporting for "affiliated organizations." Alternatives that were redeliberated and rejected by the Board were (a) the current guidance found in Statement 14, (b) extensive note disclosure of financial information for these organizations, and (c) inclusion in the primary government's financial statements as an asset (for example, "Resources held by others"). Alternatives (b) and (c) would have resulted in the creation of a separate category outside of the guidance in Statement 14 for these organizations. The Board rejected these three approaches based on the reasons outlined below.

Statement 14 Display Guidance

39. The guidance in paragraph 42 of Statement 14 states, in part: "Because of the closeness of their relationships with the primary government, some component units should be blended as though they are part of the primary government; however, most component units should be discretely presented." Paragraph 53 of Statement 14 further defines the type of component units that should be blended. A component unit is considered to be intertwined with the primary government (and therefore is required to be blended) in either of these two circumstances: (a) the component unit's governing body is substantively the same as the governing body of the primary government, or (b) 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. As previously noted, component units that meet the criteria in this Statement have a different relationship with the primary government than do other component units. The Board believes that discrete presentation is warranted because these component units, while having a close relationship with the

primary government, are *not* as intertwined as other component units that exclusively, or almost exclusively, benefit the primary government.

Note Disclosure

40. During deliberations that led to the issuance of Statement 14, the Board considered note disclosure for component units that did not meet the benchmarks for display by discrete presentation or blending. However, in Statement 14, the Board rejected note disclosure as a method of reporting *component units,* primarily because users equated “inclusion” (of component units) with display on the face of the financial statements. The Board was also concerned that labeling organizations with which the primary government had no significant ongoing relationship as “component units” would overstate those relationships. Consequently, the Board changed the terminology for Statement 14 so that those organizations that did not meet the criteria for display were classified as “related organizations,” rather than component units.

41. After consideration of comments from respondents to the 1994 Exposure Draft and the revised ED, the Board redeliberated the use of notes as a method of inclusion. Even though the majority of the respondents to the revised ED supported the note disclosure approach, the Board continues to believe that the relationship between the primary government and organizations that meet the criteria in this standard requires those organizations to be accorded *component unit* status. As discussed in paragraphs 93 through 95 in Statement 14’s Basis for Conclusions, a primary government’s relationships with component units are more significant than its relationships with its related organizations—thus, component unit financial information is required to be *displayed,* whereas limited information about related organizations is required to be *disclosed* in the

notes. Although the same type of information displayed in discrete presentation could be provided through the use of note disclosure, empirical evidence exists that is consistent with the long-standing reporting convention that note disclosure is not a substitute for display on the face of the financial statements. Research that evaluates market reaction to display of financial information versus note disclosure of the same type of information indicates that financial statement users are more likely to attribute greater significance to information that is displayed.

Line-Item Presentation

42. The Board also discussed using a line-item presentation on the statement of net assets/balance sheet of the primary government for displaying affiliated organizations. Some respondents to the revised ED suggested that line-item presentation was consistent with the guidance contained in FASB Statement 136. They believe that because the Board's decision to include "financially interrelated," as defined by that FASB Statement, in the "otherwise access" examples provided additional support for this position.

43. The line-item presentation is conceptually rooted in the primary government's control over or ownership of the net assets held by the organization. This display would have included the "net assets" of the organization to which the primary government was entitled. Similar to reporting an equity interest in a joint venture in Statement 14, this approach would consist of reporting an asset representing the participating government's entitlement to the resources held for its benefit. However, unlike a joint venture, a primary government does not have "an explicit, measurable right to the net resources of [the organizations addressed in this Statement] that is usually based on an investment of financial or capital resources . . ." (Statement 14, paragraph 72). Because the Board

emphasized the significance of the *relationship* between the component unit and the primary government as the premise of Statement 14, the Board believes that it is appropriate to display the entire operations of these component units, not merely the net resources that the primary government is entitled to from these organizations. Compared to the line-item approach, discrete presentation displays more comprehensive financial information about the organization. Although some argue that discrete presentation results in double-counting revenues—once when received by the organization, and again when distributed to the primary government—the Board believes that clearly displaying and describing the intra-entity transactions, as required for all other transactions of a similar type between a primary government and its component units, should minimize the potential for misunderstanding. In addition, the presentation of a consolidated total for the reporting entity would eliminate any double-reporting concerns.

Disclosure Requirements

44. This Statement does not affect the disclosure requirements of paragraph 61 of Statement 14 or paragraph 128 of Statement 34. For each discretely presented component unit presented as a result of this Statement, notes to the reporting entity's financial statements should include a brief description of the component units, their relationships to the primary government, a discussion of the criteria for including the component units, how these component units are reported, and for each major component unit the nature and amount of significant transactions between the primary government and the component units. An illustration of the disclosures is provided in Appendix E.

Reporting Component Units within Component Units

45. Governments that have component units based on the criteria in this Statement may, themselves, be component units of another government. For example, a state university that has a fund-raising foundation component unit may be a component unit of the state. Paragraph 43 of Statement 34 requires that the component unit (the state university) financial data that are incorporated into a reporting entity's (the state) financial statements should include the data from its component units (the fund-raising foundation). In addition, paragraph 50 of Statement 14, as amended, requires that the component unit (the state university) information included in the state's reporting entity should be the aggregated entity totals (the state university combined with its component units). Paragraph 61 of Statement 14 requires that the notes to the reporting entity's (the state) financial statements include a description of its component units. To more fully describe the relationships with its component units, a reporting entity (the state) may provide additional information about the component units (the fund-raising foundation) of its component units (the state university) in that disclosure. In addition, the required disclosure about how the separate financial statements for the university may be obtained could acknowledge that those separate statements include information about the university's component units.

Different Fiscal Year-ends

46. Some respondents commented about the possibility of a qualified auditor's opinion on the reporting entity's financial statements if the financial statements of the organizations deemed to be component units by this Statement are not available for timely inclusion. Similar concerns were raised during the due process associated with Statement

14. Paragraph 59 of Statement 14 addresses different reporting periods for the primary government and its component units. Effectively, it allows the primary government to include up to eleven-month-old financial statements of the component unit in its financial statements.

Different Reporting Formats

47. Another concern expressed by some respondents related to component units that report using a different generally accepted accounting principles (GAAP) reporting format than most primary governments do. However, the answer to question 104 in the *Guide to Implementation of GASB Statement 14 on the Financial Reporting Entity* states, in part: "Any noncompatible or additional statements required by the component unit's reporting model would not be combined with either governmental or proprietary component units, but instead would be presented as separate statements in the [general purpose financial statements]." Therefore, component units that use different GAAP reporting models need not be presented on the same page as the primary government, but may be reported on separate pages. In addition, Appendix E provides illustrative financial statements that demonstrate how information presented in a *nongovernmental* format can be presented so that it is "compatible" with the primary government's financial statement formats.

Other Concerns

48. During the due process that led to the issuance of this Statement, a variety of concerns were expressed by constituents in their comment letters to the Exposure Drafts and in their testimonies at the public hearings. Most of those issues are addressed in the preceding paragraphs of this appendix; however, there were two additional areas of concern—potential reduction in state appropriations and the possibility for diminished

donations—that arose from constituents' expectations about the possible consequences of implementing the provisions of this Statement. The GASB's mission statement directs the Board to "issue standards that improve the usefulness of financial reports based on the needs of financial report users; on the primary characteristics of understandability, relevance, and reliability; and on the qualities of comparability and consistency." In setting standards, the Board is guided by several principles, including *objectivity* and *neutrality* in decision making. The mission statement provides that "objective and neutral mean freedom from bias, precluding the GASB from placing any particular interest above the interests of the many who rely on the information contained in financial reports." Thus, the Board's primary concern is that this Statement will result in the reporting of relevant and reliable information, even though the information provided may affect different users in different ways. The Board believes that the inclusion of the information required by this Statement will clarify existing guidance and lead to more consistent, complete, and reliable information about the financial reporting entity. To minimize the chances that the information may be misinterpreted, the Board encourages governments to use the medium provided through note disclosures to clearly describe the relationships of component units to the primary government and, thus, help the user understand the extent to which the primary government can or cannot *control* an organization or *marshal* its resources.

49. Concerns were raised by some respondents that action may be taken to reduce governmental appropriations if the component unit's (for example, a fund-raising foundation's) resources were required to be included in the financial statements of the primary government (for example, a state university). The Board understands that

preparers are concerned that including these organizations in their financial statements might imply greater resources than the primary government can actually control, and that this implication may affect public policy regarding public funding. It also realizes that many state-funded organizations have previously not included their fund-raising or financing organizations in their financial statements, so it is difficult to predict the effect on state funding that could result. However, the Board believes that legislative bodies have been aware of, or were able to obtain information about, significant fund-raising foundations. For example, prior to the issuance of this Statement, many entities that did not display the financial statement data of fund-raising foundations nevertheless included information about those foundations in the notes to their financial statements.

50. Finally, some respondents representing organizations that would meet the component unit criteria in this Statement expressed concern that their contributions would diminish because donors would be hesitant to contribute to organizations that were perceived to be controlled by a governmental organization. However, the Board believes that most donors to fund-raising organizations that serve governmental educational, health, art, or other organizations realize that their donations are going to further the mission of a *governmental* entity. Again, the required disclosures about the relationships between primary governments and their component units afford governments the opportunity to clearly describe the extent to which a primary government can control a component unit and its resources.

Effective Date

51. The Board believes that an effective date for years beginning after June 15, 2003, provides adequate time to identify potential component units, assess those organizations

based on the criteria, and gather financial information for those organizations that are determined to be component units. Earlier application of this Statement is encouraged.

Appendix C

ILLUSTRATIVE EXAMPLES

52. The examples presented in this appendix are intended to illustrate how the criteria in paragraph 5 of this Statement would be applied in several hypothetical situations. Paragraph 5 amends Statement 14 to require legally separate, tax-exempt organizations to be discretely presented as component units if *all three* 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 [the "direct benefit" criterion].
2 The primary government, or its component units, is entitled to, or has the ability to otherwise access, a majority of the economic resources received or held by the separate organization [the "entitlement/ability to access" criterion].
3. The economic resources received or held by an *individual organization* that the specific primary government, or its component units, is entitled to, or has the ability to otherwise access, are significant to that primary government [the "significance" criterion].

These examples are for illustrative purposes only and are nonauthoritative. Application of this Statement to individual governments requires consideration of the circumstances specific to those governments.

Example 1: Library Foundation

Facts: ABC Library Foundation was established as a legally separate, tax-exempt organization to support ABC Public Library. The foundation has a history of supporting the library with a majority of the financial resources it raises. Throughout the year, the library requests funding from the foundation to support various projects. The resources distributed to the library in any single year may or may not be significant, but the resources held by the foundation are significant to the library.

Conclusion: ABC Library Foundation is a component unit of ABC Public Library and should be discretely presented in ABC Public Library's reporting entity financial statements. The foundation's resources are almost entirely for the benefit of ABC Public Library and the "entitlement/ability to access" criterion is met because the foundation has a history of supporting the library with its economic resources. Finally, the resources received or held by the foundation that the library is entitled to are significant to the library.

Example 2: Art Foundation

Facts: The Carol Sauer Art Foundation was established as a legally separate, tax-exempt organization to support fine arts in the greater Anytown metro area. The foundation has a history of providing substantial financial support to several different entities each year including XYZ Art Museum, Anytown's public museum; community theatre groups; and other organizations with objectives consistent with the foundation's charter. Occasionally, donations received by the foundation are restricted for the benefit of specific organizations, but generally, restricted donations are distributed currently, rather than held. An accumulation of restricted resources would not be significant to any of the designated beneficiaries. The support given to XYZ Art Museum during the current year was significant to the museum. However, depending on the ongoing needs of other qualifying organizations and the foundation's resources available for distribution, this level of support to the museum has varied considerably over the years.

Conclusion: The Carol Sauer Art Foundation is not *required* to be reported as a component unit of XYZ Art Museum because at least one of the three criteria is not satisfied. The "direct benefit" criterion is not met because the foundation supports several other organizations, and the resources it receives and holds are not entirely or almost entirely restricted for the benefit of XYZ Art Museum. Because the first criterion is not met, neither the "entitlement/ability to access" criterion nor the "significance" criterion needs to be considered. However, the "incomplete or misleading to exclude" concept in paragraph 41 of Statement 14 should be considered.

Example 3: University Alumni Association

Facts: KMH University Alumni Association was established as a legally separate, tax-exempt organization to support both KMH University and students of the university. Generally, when the university awards a scholarship to a student who meets the criteria established by the alumni association, the university requests funds from the alumni association's resources. Normally, the alumni association honors the request and transfers the funds to the university. In the current year, the alumni association endows a chair and fourteen scholarships for the KMH University School of Business and donates the funds to KMH University. The funds donated directly to the university and the resources held by the association are significant to the university's financial statements.

Conclusion: KMH University Alumni Association is a component unit of the university and should be discretely presented in the university's reporting entity financial statements. The alumni association's resources are entirely for the direct benefit of the university or the university's students. The "entitlement/ability to access" criterion is met because the association has historically complied with the university's requests for funding. In addition, the resources received and held by the association that are required to be used for the benefit of the university or to provide scholarships to deserving students are significant to the university.

Example 4: Booster Club

Facts: BBR High School Booster Club was established as a legally separate, tax-exempt organization to provide support for extracurricular activities of BBR High School, which is part of Public School District #115. Historically, the booster club has provided funds to the high school to charter buses to transport the school football team to its away games each year and to cover the school's cost of replacing the marching band's uniforms every five years. The club solicits contributions from area merchants and conducts annual fundraisers, such as bake sales, carnivals, and car raffles. Although the booster club provides financial support for the charter buses and band uniforms, these funds are insignificant to the school district.

Conclusion: The booster club is not *required* to be reported as a component unit of Public School District #115 because one of the three criteria is not met. BBR High School Booster Club's economic resources are entirely for the direct benefit of the high school and the "entitlement/ability to access" criterion is met because the booster club historically has supported the high school's activities. However, the third criterion is not met because the economic resources received or held by the booster club that are required to be used for the benefit of the high school are insignificant to the school district.

Example 5: University Fund-Raising Foundation

Facts: CCB University Foundation is a legally separate, tax-exempt organization whose bylaws state that it exists solely to provide financial support to CCB University. The foundation regularly makes distributions directly to the university and pays for the maintenance of the university's football stadium and auditorium (by making payments directly to vendors and contractors rather than the university). Separately, the direct cash payments to the university and the maintenance expenses of the university paid by the foundation are not significant to the university—combined, however, they are significant. The economic resources of the foundation that are restricted for the benefit of the university are significant.

Conclusion: CCB University Foundation is a component unit of the university and should be discretely presented in the university's reporting entity financial statements. The language in the foundation's bylaws satisfies the "direct benefit" criterion, and the "entitlement/ability to access" criterion is met due to the foundation's history of supporting the university. The "significance" criterion is met because the combined resources used by university activities and the restricted resources held by the foundation are deemed to be significant to the university, regardless of the extent to which those resources may be used for "in-kind" assistance to the university.

Example 6: University Research Foundation

Facts: Ten years ago, the State University Research Foundation was established as a legally separate, tax-exempt organization to provide the buildings, laboratory facilities, and administrative support necessary for the faculty of State University to competitively attract and carry out research grants, principally from the federal government and corporations. The total research and administrative costs of the foundation were significant to the university in the current year. The foundation occupies two buildings on campus, constructed by it on land leased from the university. A significant portion of instructional faculty in the School of Engineering, Science, and Technology carry out research at the foundation, and their annual performance evaluations and merit increases at the university give formal consideration to the research they perform at the foundation.

The completion of a research grant typically results in the submittal of a report of research findings and recommendations to the grantee and, often, the publication of results in academic and professional journals. This research activity is deemed integral to the duties of faculty and is consistent with the university's mission.

A formal agreement between the university and the foundation requires the foundation to make its general lecture and meeting rooms available, upon request, to the university, and to make certain research laboratories available for special lectures and seminars. The university's personnel office provides administrative support for the hiring of foundation personnel, including research technicians who typically are selected by committees of faculty. The relationship between the university and the foundation is disclosed in a brochure used to inform prospective faculty of the university.

Students enrolled in university graduate courses work at the foundation as research assistants. They are compensated through stipends paid by research grants, or under financial aid work-study programs administered by the university. Faculty are required to periodically report their research, instructional, and other efforts through an effort reporting system jointly administered by the foundation and the university. Faculty working on research grants typically receive a portion of their compensation from grant funds.

Conclusion: The foundation is not *required* to be reported as a component unit because at least one of the criteria is not met. The "direct benefit" criterion is not satisfied because a substantial portion of the economic resources it receives and holds are for the benefit of private companies and the federal government, rather than the university. Because the first criterion is not met, neither the "entitlement/ability to access" criterion nor the "significance" criterion needs to be considered. However, given the manner in which the foundation is *financially integrated* with the university, a further evaluation should be made to determine whether, as a matter of professional judgment, the nature and significance of the foundation's relationship with the university warrant its inclusion in the university's financial statements as a component unit.

Example 7: Hospital Foundation

Facts: MLC Memorial Hospital Foundation was established as a legally separate, tax-exempt organization to solicit individual and corporate donations and otherwise raise funds to provide financial support to the MLC Memorial Hospital. The foundation operates a gift shop in the hospital and has helped finance several of the hospital's capital projects including the building of a new children's wing. All of the profits from the gift shop are used to buy new furniture for the hospital. The foundation buys the furniture and donates it to the hospital. The foundation's resources, to which the hospital is entitled, are significant to the hospital's financial statements.

Conclusion: MLC Memorial Hospital Foundation is a component unit of the hospital and should be discretely presented in the hospital's reporting entity financial statements. Because the foundation's charter establishes the hospital as its exclusive beneficiary, the "direct benefit" criterion is met; likewise, the "entitlement/ability to access" criterion is satisfied as a result of the history of support provided by the foundation. In addition, the economic resources received or held by the foundation that the hospital is entitled to are significant to the hospital.

Example 8: School District Parent–Teacher Organization (PTO)

Facts: Parents of students in a public school district created a legally separate, tax-exempt PTO to raise private funds that supplement the state and local funding to their children's school district. These resources are required to be used exclusively for the benefit of the school district. The PTO solicits funds year-round and sponsors an annual drive to perpetuate and secure the future contributions to the school district. The funds raised, or the income earned thereon, are contributed to the school district as determined by the board of the PTO, but generally the PTO retains only enough resources to cover its fund-raising and other operational expenses. The PTO is a "financially interrelated" organization based on the guidance of FASB Statement 136. The funds raised and given to the school district in the current year are significant to the school district.

Conclusion: The PTO is a component unit of the school district and should be discretely presented in the district's reporting entity financial statements. The PTO is a legally separate, tax-exempt entity whose resources are entirely for the direct benefit of the school district. Because the PTO is a "financially interrelated" organization, the "entitlement/ability to access" criterion is satisfied; furthermore, the "significance" criterion is met because, even though the resources held by the PTO are negligible, the resources raised and distributed annually are significant to the district.

Example 9: Music Instruction Program

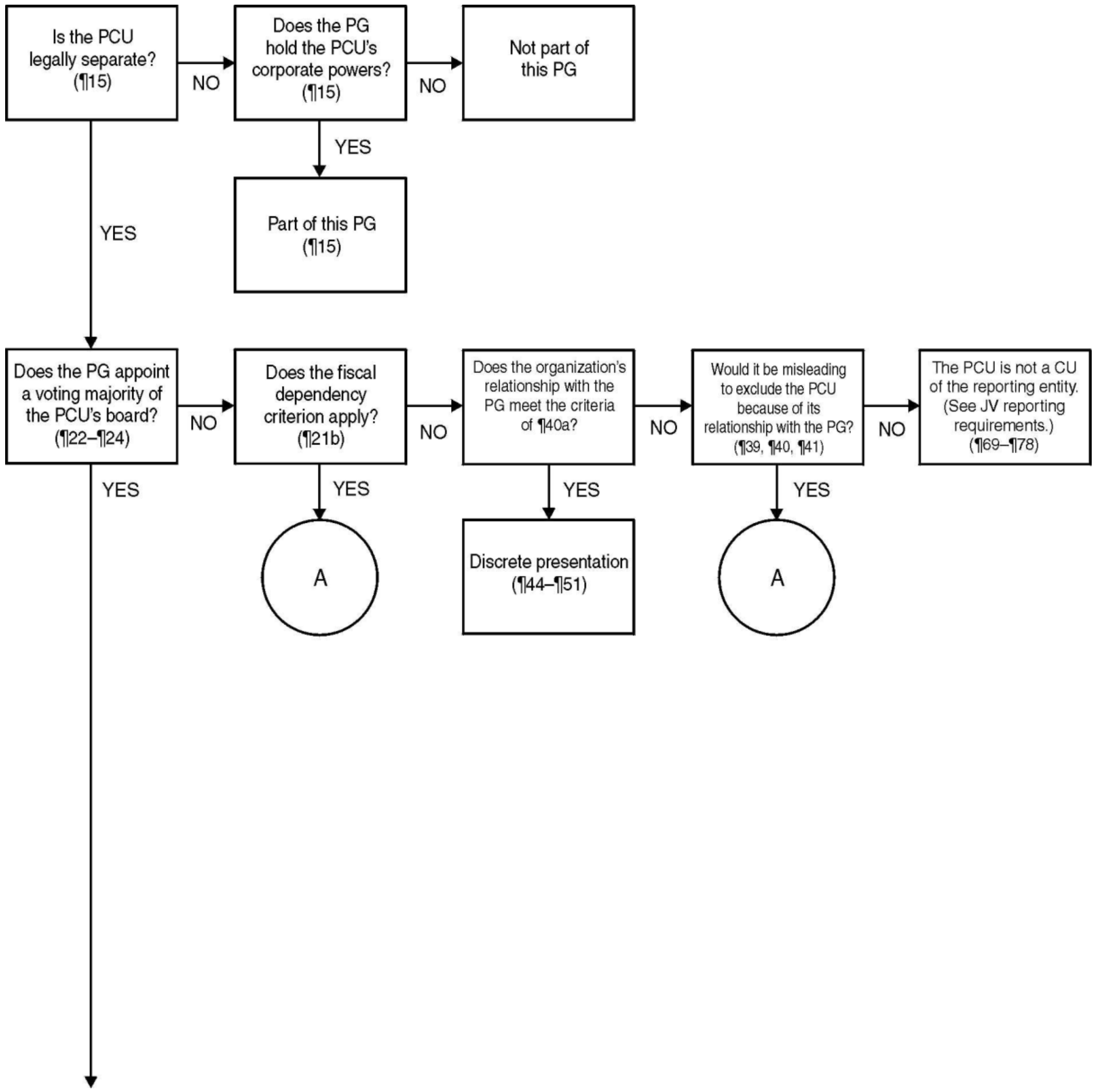
Facts: A school district did not have a music program as part of its curriculum. Several parents formed a group and hired a music instructor who was not an employee of the school district. In addition, the parents group entered into an agreement with the district to rent classroom space after school hours to hold the music lessons. The parents share the expenses of the program based on a per-child allocation of the total cost. The rental payments made to the school district were insignificant to the district.

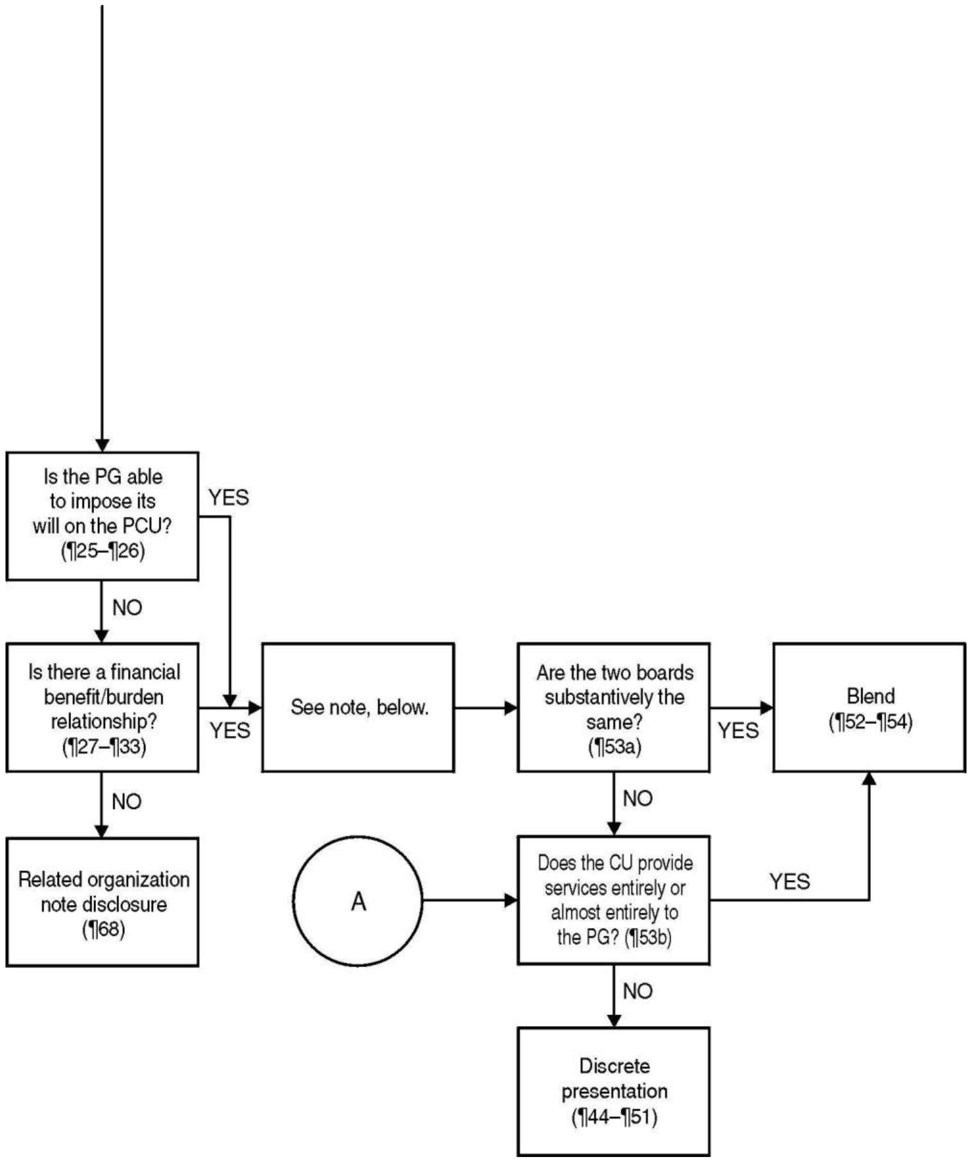
Conclusion: The music program is not a component unit of the school district because the parents group that established the after-school music program did not separately incorporate or apply for tax exemption. Thus there is no "organization" to which the three criteria for inclusion would be applied.

Appendix D

FLOWCHART FOR EVALUATING POTENTIAL COMPONENT UNITS

53. The following flowchart is intended to aid in the application of the provisions of Statement 14, as amended by this Statement, to a particular reporting entity. It includes references to specific paragraphs in Statement 14, as amended, that provide a detailed explanation of the particular topic. The flowchart is nonauthoritative and should not be used in place of the Statement itself.


Is the PCU legally separate? (¶15)
NO
Does the PG hold the PCU's corporate powers? (¶15)
NO
Not part of this PG
YES
Part of this PG (¶15)
YES
Does the PG appoint a voting majority of the PCU's board? (¶22–¶24)
NO
Does the fiscal dependency criterion apply? (¶21b)
NO
Does the organization's relationship with the PG meet the criteria of ¶40a?
NO
Would it be misleading to exclude the PCU because of its relationship with the PG? (¶39, ¶40, ¶41)
NO
The PCU is not a CU of the reporting entity. (See JV reporting requirements.) (¶69–¶78)
YES
YES
A
YES
Discrete presentation (¶44–¶51)
YES
A



Note: A potential component unit for which a primary government is financially accountable may be fiscally dependent on another government. An organization should be included as a component unit of only one reporting entity. Professional judgment should be used to determine the most appropriate reporting entity (paragraphs 21b and 34–38). A primary government that appoints a voting majority of the governing board of a component unit of another government should make the disclosures required by paragraph 68 for related organizations.

PCU = Potential component unit CU = Component unit PG = Primary government

Appendix E

ILLUSTRATIONS

54. The following illustrations are intended to aid in the application of the provisions of this Statement in a hypothetical situation. The statements and disclosures are illustrative only and should not be considered authoritative. Management's discussion and analysis, other basic financial statements, notes to financial statements, and other required contents are not illustrated; thus these illustrative financial statements do not meet the minimum requirements for a complete set of GAAP financial statements and required supplementary information.

55. Exhibits E-1 and E-2 illustrate selected financial statements for a hypothetical nonprofit fund-raising organization that uses a nongovernmental GAAP reporting model and is a component unit of a public university, based on the application of the criteria in this Statement. In this example, the university chose to discretely present the foundation by displaying the foundation's financial statements in their original formats on separate pages. In the university's reporting entity financial statements, the foundation's statement of net assets would follow the university's statement of net assets; similarly, the foundation's statement of activities would be presented on the page following the university's statement of activities. Although the reporting formats of the foundation, in some ways, are different from those of the university, they are not completely "incompatible." That is, the information in the foundation's statements can be reconfigured to allow for a side-by-side columnar presentation with the university.

Exhibits E-3 and E-4 illustrate how the foundation's financial statements can be modified to conform to the enterprise fund reporting requirements in Statement 34.

56. If the university is a component unit of a state, the component unit financial data on pages E-1 and E-2 would be required to be combined with the university's financial data so that the combined totals could be included in the state's government-wide statements, as required by paragraph 50 of Statement 14, as amended. If the university used the side-by-side approach illustrated in E-3 and E-4, it has the option of displaying an entity total column and carrying forward the combined (after eliminations) data from that column to the state's government-wide statements, or not displaying the total column, but carrying forward the combined totals that would have been displayed in the total column.

Exhibit E-1

ABC University Foundation
Statement of Net Assets
June 30, 2002

Assets	
Cash and cash equivalents	$ 9,822,992
Notes and mortages receivable, net	107,200
Endowment investments	208,026,940
Investments in real estate	1,478,316
Capital assets, net	1,981,151
Total assets	221,416,599
Liabilities	
Accounts payable and accrued liabilities	26,369,439
Deposits	319,700
Long-term liabilities	781,809
Total liabilities	27,470,948
Net assets	
Unrestricted	15,000,073
Temporarily restricted	44,474,889
Permanently restricted	134,470,689
Total net assets	$ 193,945,651

Exhibit E-2

ABC University Foundation
Statement of Activities
For the Year Ended June 30, 2002

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Revenues				
Gifts	$ 2,364,303	$ 12,270,930	$ 12,426,435	$ 27,061,668
Interest on investments	2,960,455	1,967,326	1,976,041	6,903,822
Gain on sale of investments	1,640,350	5,467,832	3,827,483	10,935,665
Rental income	6,832	—	—	6,832
Gain on sale of real estate	—	—	269,651	269,651
Other income	20,502	—	—	20,502
Reclassifications	21,917,693	(21,917,693)	—	—
Total revenues	28,910,135	(2,211,605)	18,499,610	45,198,140
Expenses				
Salaries	1,027,247	—	—	1,027,247
Benefits	240,327	—	—	240,327
Payments to or for ABC University	20,317,471	—	—	20,317,471
Distributions to beneficiaries of life income and life estates	1,180,486	—	—	1,180,486
Investment expenses	807,569	—	—	807,569
Utilities	42,713	—	—	42,713
Supplies and other services	554,861	—	—	554,861
Depreciation	80,404	—	—	80,404
Total expenses	24,251,078	—	—	24,251,078
Change in net assets	4,659,057	(2,211,605)	18,499,610	20,947,062
Net assets—beginning of the year	10,341,016	46,686,494	115,971,079	172,998,589
Net assets—end of the year	$ 15,000,073	$ 44,474,889	$ 134,470,689	$ 193,945,651

ABC University
Statement of Net Assets
June 30, 2002

Exhibit E-3

	ABC University	Component Unit ABC Foundation
ASSETS		
Current assets:		
Cash and cash equivalents	$ 5,003,481	$ 9,822,992
Short-term investments	15,278,981	—
Accounts receivable, net	6,412,520	—
Inventories	585,874	—
Deposit with bond trustee	4,254,341	—
Notes and mortgages receivable, net	359,175	107,200
Total current assets	31,894,372	9,930,192
Noncurrent assets:		
Restricted cash and cash equivalents	24,200	—
Endowment investments	21,548,723	208,026,940
Notes and mortgages receivable, net	2,035,323	—
Investments in real estate	6,426,555	1,478,316
Land and construction in progress	25,125,310	—
Capital assets, net	133,852,019	1,981,151
Total noncurrent assets	189,012,130	211,486,407
Total assets	220,906,502	221,416,599

Exhibit E-3 (continued)

	ABC University	Component Unit ABC Foundation
LIABILITIES		
Current liabilities:		
Accounts payable and accrued liabilities	4,897,470	26,369,439
Deferred revenue	3,070,213	—
Long-term liabilities—current portion	4,082,486	125,000
Total current liabilities	12,050,169	26,494,439
Noncurrent liabilities:		
Deposits	1,124,128	319,700
Deferred revenue	1,500,000	—
Long-term liabilities	31,611,427	656,809
Total noncurrent liabilities	34,235,555	976,509
Total liabilities	46,285,724	27,470,948
NET ASSETS		
Invested in capital assets, net of related debt	126,861,400	1,199,342
Restricted:		
Nonexpendable:		
Scholarships and fellowships	10,839,473	96,074,430
Research	3,767,564	38,396,259
Expendable:		
Scholarships and fellowships	2,803,756	—
Research	5,202,732	—
Instructional department uses	938,571	44,474,889
Loans	2,417,101	—
Capital projects	4,952,101	—
Debt service	4,254,341	—
Other	403,632	—
Unrestricted	12,180,107	13,800,731
Total net assets	$ 174,620,778	$ 193,945,651

Exhibit E-4

ABC University
Statement of Revenues, Expenses, and Changes in Net Assets
For the Year Ended June 30, 2002

	ABC University	Component Unit ABC Foundation
REVENUES		
Operating revenues:		
Student tuition and fees (net of scholarship allowances of $3,214,454)	$ 36,913,194	$ —
Gifts and contributions	—	14,635,233
Federal contracts	10,641,613	—
Nongovernmental grants and contracts	3,873,740	—
Sales and services of educational departments	19,802	—
Auxiliary enterprises:		
Residential life (net of scholarship allowances of $428,641)	28,079,274	—
Bookstore (net of scholarship allowances of $166,279)	9,092,363	—
Other operating revenues	143,357	27,334
Total operating revenues	88,773,343	14,662,567
EXPENSES		
Operating expenses:		
Salaries:		
Faculty	52,300,801	—
Exempt staff	32,443,845	1,027,247
Nonexempt wages	5,913,762	—
Benefits	18,486,559	240,327
Scholarships and fellowships	3,809,374	—
Utilities	16,463,492	42,713
Supplies and other services	12,451,064	554,861
Depreciation	6,847,377	80,404
Total operating expenses	148,716,274	1,945,552
Operating income (loss)	(59,942,931)	12,717,015

Exhibit E-4 (continued)

	ABC University	Component Unit ABC Foundation
NONOPERATING REVENUES (EXPENSES)		
State appropriations	30,710,504	—
Gifts, including $20,317,471 from ABC Foundation	22,139,913	—
Federal grants	9,050,004	—
Investment income (net of investment expense of $87,316 for the University and $807,569 for the Foundation)	2,182,921	17,340,659
Interest on capital asset–related debt	(1,330,126)	(39,090)
Payments to ABC University	—	(20,317,471)
Distributions to life income and life estate beneficiaries	—	(1,180,486)
Other nonoperating revenues (expenses)	313,001	—
Net nonoperating revenues	63,066,217	(4,196,388)
Income before other revenues, expenses, gains, or losses	3,123,286	8,520,627
Capital appropriations	2,075,750	—
Capital grants and gifts	690,813	—
Additions to permanent endowments	85,203	12,426,435
Increase in net assets	5,975,052	20,947,062
NET ASSETS		
Net assets—beginning of year	168,645,726	172,998,589
Net assets—end of year	$ 174,620,778	$ 193,945,651

Illustrative Component Unit Note (in the University's Financial Statements)

The following disclosure meets the requirements in paragraph 61 of Statement 14 and paragraph 128 of Statement 34:

ABC University Foundation (foundation) is a legally separate, tax-exempt component unit of ABC University (university). The foundation acts primarily as a fund-raising organization to supplement the resources that are available to the university in support of its programs. The seven-member board of the foundation is self-perpetuating and consists of graduates and friends of the university. Although the university does not control the timing or amount of receipts from the foundation, the majority of resources, or income thereon, that the foundation holds and invests are restricted to the activities of the university by the donors. Because these restricted resources held by the foundation can only be used by, or for the benefit of, the university, the foundation is considered a component unit of the university and is discretely presented in the university's financial statements.

During the year ended June 30, 200X, the foundation distributed $20,317,471 to the university for both restricted and unrestricted purposes. Complete financial statements for the foundation can be obtained from the Administrative Office at 317 Denise Road, Elizabeth, CT 12345 or from the foundation's website at www.foundation.edu.

The following disclosure is not required by this Statement, but may be useful in the summary of significant accounting policies:

The foundation is a private nonprofit organization that reports under FASB standards, including FASB Statement No. 117, *Financial Reporting for Not-for-Profit Organizations.* As such, certain revenue recognition criteria and presentation features are different from GASB revenue recognition criteria and presentation features. No modifications have been made to the foundation's financial information in the university's financial reporting entity for these differences.

Illustrative Component Unit Note (in a State Government's Financial Statements)

Paragraph 61 of Statement 14 requires that the notes to the reporting entity's financial statements include a description of its component units. To more fully describe the relationships with its component units, a reporting entity (a state, for example) may provide additional information about the component units (a fund-raising foundation) of its component units (a state university system) in that disclosure. The following sample disclosure satisfies the requirements in paragraph 61, and includes additional information (similar to the illustrative disclosure above) about the fund-raising foundations that are included in the financial statements of the state university system, one of the state's discretely presented component units. This additional information is

not required, so governments may choose to disclose more or less detail than is illustrated in this example.

State University Component Unit: This component unit is composed of the fifteen colleges and universities that are members of the State System of Higher Education (the system). Each institution in the system is governed by a Board of Regents. The Boards of Regents consist of five to ten members appointed by the governor, with the advice and consent of the Senate. The state can impose its will on each of the institutions through its ability to modify and approve their budgets and its ability to approve or modify fee (tuition) changes. In addition, the state provides financial support to the colleges and universities through annual operating and capital appropriations. Also included in the system are the financial data of the institutions' fund-raising foundations. Although the universities do not control the timing or amount of receipts from their foundations, the majority of resources, or income thereon, that the foundations hold and invest are restricted to the activities of the respective universities by the donors. Because these restricted resources held by the foundations can only be used by, or for the benefit of, the specific universities, the foundations are considered component units of the universities and are included in the universities' financial statements. Separately issued audited financial statements for each college or university may be obtained from the Office of State Finance, 206 Kristin Blvd., Capital City, CT 12543.

Appendix F

CODIFICATION INSTRUCTIONS

57. The sections that follow update the June 30, 2001, *Codification of Governmental Accounting and Financial Reporting Standards: Statement 34 Edition* for the effects of this Statement. Only the paragraph reference is included if the paragraph is cited in its entirety.

* * *

DEFINING THE FINANCIAL REPORTING ENTITY SECTION 2100

Sources: [Add the following:] GASBS 39

Certain Organizations Included in the Reporting Entity

.138 [Revise paragraph as follows:] Paragraph .111(c) requires that certain organizations should be included as component units if 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, are such that exclusion from the financial reporting entity would render the financial reporting entity's financial statements incomplete or misleading. [GASBS 14, ¶39; GASBS 39, ¶5]

[Insert new paragraph .140 and renumber subsequent paragraphs.]

.140 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:

a. 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.

b. The primary government, or its component units, is entitled to, or has the ability to otherwise access,[5] a majority of the economic resources received or held by the separate organization.

c. The economic resources received or held by an *individual organization* that the specific primary government, or its component units, is entitled to, or has the ability to otherwise access, are significant to that primary government.

[GASBS 39, ¶5]

[5]The ability of the 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 .128, 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*. [GASBS 39, ¶5]

.141 [Revise current paragraph .140 as follows:] In addition, other organizations should be evaluated as potential component units if they are closely related to, or financially integrated[6] 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. [GASBS 14, ¶41; GASBS 39, ¶6]

[6]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. [GASBS 39, ¶6]

Reporting Component Units

.142 [Revise current paragraph .141 as follows:] Financial statements of the reporting entity should provide an overview of the entity, yet allow users to distinguish between the primary government and its component units. Because of the closeness of their relationships with the primary government, component units that meet the criteria of Section 2600, paragraph .113, should be blended as though they are part of the primary government. However, most component units, including those that meet the criteria of paragraph .140, should be discretely presented. Both blending and discrete presentation are discussed in Section 2600. [GASBS 14, ¶42; GASBS 39, ¶7]