Component Units: Financial Benefit or Burden?
GASB 61 Clarifies this Criterion’s Intent & Application – & Others

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Executive Summary

The amendments brought about in the Governmental Accounting Standards Board (GASB) Statement No. 61, “The Financial Reporting Entity: Omnibus – an amendment of GASB Statements No. 14 and No. 34,” are comprehensive. GASB 61 amends criteria for including, presenting and disclosing information about component units and other related organizations in a government reporting entity’s financial statements. The criteria for blending component units are more restrictive than those required under Statement No. 14, requiring a potential financial benefit or burden relationship between the primary government and a fiscally dependent component unit. Blending also is required when a component unit’s total debt outstanding is expected to be repaid entirely or almost entirely with the primary government’s resources, or if the component unit entirely or almost entirely serves or benefits the primary government. Statement No. 61 is effective for financial reporting periods beginning after June 15, 2012.

Background

Entity structures and relationships vary from government to government. As a result, defining, accounting and reporting on the financial reporting entity consistently across governments can be challenging. Since the 1991 issuance of GASB Statement No. 14, “The Financial Reporting Entity,” and subsequent to its amendment in 2002 by GASB Statement No. 39, “Determining Whether Certain Organizations Are Component Units—an amendment of GASB Statement No. 14,” many questions about Statement 14 requirements have arisen, and certain areas have become recurring topics for technical inquiries.

In response for additional guidance, in January 2006, GASB placed the Statement 14 Reexamination Project on its agenda. The objective of the project was to determine whether financial statement users, preparers and attesters believe that reporting entities applying that standard’s requirements are including all organizations that should be included and excluding organizations that should not be included. In other words, the goal was to determine whether the reporting entity framework—the criteria for inclusion of component units, the display and disclosure requirements and other provisions established in Statement 14, as amended with Statement 39—is still appropriate and provides financial statement users with useful information in a cost-effective manner. The project also re-examined whether the financial information of the included organizations is displayed and disclosed in the most appropriate and useful manner.

As a result of this re-examination, GASB issued Statement No. 61, “The Financial Reporting Entity: Omnibus – an amendment of GASB Statements No. 14 and No. 34.” GASB 61 is effective for periods beginning after June 15, 2012. Statement 61 applies to financial reporting by primary governments and other standalone governments, as well as to separately issued financial statements of governmental component units, as defined in Statement 61.

Statement 61 modifies existing requirements for including, presenting and disclosing information about component units and equity interest transactions of a financial reporting entity, clarifying and amending the standards in Statement 14 and Statement No. 34, “Basic Financial Statements – and Management’s Discussion and Analysis – for State and Local Governments,” in eight areas:

1. Definition of a Component Unit
2. Component Units – Notes
3. Definition of “Major” Component Unit
4. Major Component Unit – Reporting
5. Component Unit Blending Criteria
6. Component Unit Blending – Reporting
7. Equity Interest Reporting
8. Minority Interests in Component Units and Related Organizations with Joint Venture Characteristics Reporting
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The amendments of Statement 61 apply to primary governments, standalone governments, separately-issued financial statements of governmental components and nongovernmental component units when included in a governmental financial reporting entity. They also enhance the financial reporting guidance for all governments that have component units, joint ventures, related organizations or similar relationships.

GASB 61 Changes in Depth

Definition of a Component Unit

Statement 14 identifies two general categories of related organizations that should be evaluated as potential component units: those component units for which the primary government is financially accountable and those for which the primary government is not. A potential component unit can be a governmental organization or a not-for-profit or for-profit corporation.

Financially Accountable

Project research results indicated that for many financial statement users, financial interdependency between the primary government and its component units is the most important relationship for determining which organizations should be included in a financial reporting entity. This determination is in line with the foundational premise of Statement 14 that financial accountability is the primary benchmark for inclusion in a governmental financial reporting entity.

Elected officials of the primary government are often considered accountable to the public for the decisions they make related to their authority over a fiscally dependent government, regardless of whether there was any financial interdependency—potential financial benefits or burdens—between the primary government and a fiscally dependent government. A government is considered fiscally dependent if it cannot (a) determine and modify its budget; (b) establish its rates, tax levies or charges; and (c) issue bonded debt, without the approval or modification of another government.

Statement 61 does clarify—and, the board believes, improves—the fiscal dependency criteria. It requires a financial benefit or burden criteria also be present in order for a legally separate entity fiscally dependent on the primary government to be included as a component unit of the primary entity, regardless of whether the primary government appoints a voting majority of the organization’s governing body. GASB believes excluding those fiscally dependent organizations that do not also meet the financial benefit or burden criteria would appropriately increase emphasis on the information in the financial statements most relevant to the needs of the greatest number of users.

Editor’s Note: A financial benefit or burden relationship exists if the primary government is (a) legally entitled to or can access the organization’s resources, or (b) legally obligated or has otherwise assumed the obligation to finance deficits of, or provide financial support to the organization or (c) obligated in some manner for debt of the organization.

Statement 61 does not amend the criteria that a primary government’s financial accountability for a legally separate organization is established when 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.

Not Financially Accountable

Even with the clarified fiscal dependency criteria afforded by Statement 61, GASB continues to recognize that in some cases, when the financial accountability criteria is not met, professional judgment would indicate that
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Inclusion as a component unit would be appropriate in situations where the nature and significance of the organization’s relationship with the primary government are such that exclusion would cause the reporting entity’s financial statements to be misleading.

Statement 39 already clarifies what types of relationships generally should be considered in determining whether it would be misleading to exclude a potential component unit from the financial reporting entity, amending Statement 14 by establishing criteria for determining these circumstances. In general, it requires reporting as a component unit a legally separate, tax-exempt organization, the resources of which are used principally to provide significant support to the primary government or its component units.

Statement 61 further clarifies Statement 14’s intent and application by emphasizing the consideration, rather than the required inclusion, of organizations whose exclusion may render the statements misleading if those organizations are closely related to or financially integrated with the primary government. In other words, Statement 61 allows, through exercise of management’s professional judgment, for the inclusion of an organization that does not meet the financial accountability criteria. The impetus is on management; any organization closely related to (with an emphasis on financial relationships), or financially integrated with, the primary government should be evaluated as a potential component unit. 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.

Management is no longer required to determine, through exercise of its professional judgment, whether the inclusion of an organization not meeting the financial accountability criteria is necessary to ensure completeness of the reporting entity’s financial statements. Management is only required to determine whether inclusion is necessary to prevent the reporting entity’s financial statements from being misleading—allowing for more practical application of the “exercise of professional judgment” provision.

Component Units – Notes

Notes to the reporting entity’s financial statements should continue to include a brief description of the component units of the financial reporting entity and the component unit’s relationship to the primary government, as well as reasons for inclusion. With the Statement 61 amendments, disclosure of the unit’s significance relative to the total discretely presented component units is omitted.

Noting management’s exercise of professional judgment when determining which component units to include in the primary government financial statements, the requirement in Statement 14 to “include a discussion of the criteria for including the component units in the financial reporting entity and how the component units are reported” is amended in Statement 61. It now reads “include a discussion of the rationale for including each component unit in the financial reporting entity and whether it is discretely presented, blended, or included in the fiduciary fund financial statements.” Component units may be disclosed together when they have common characteristics, as long as each component unit is separately identified.

Statement 61 emphasizes the note disclosure requirements of Statement 14 generally apply to each component unit, rather than component units in general.

Definition of “Major” Component Unit

Statement 61 clarifies the types of relationships affecting the determination of major component units, eliminating the requirement that the determination include consideration of each component unit’s significance relative to other component units. The determination that a component unit is “major” is based only on the nature and
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The significance of its relationship to the primary government. This determination is generally based on one of the following factors:

1. The services provided by the component unit to the citizenry are such that separate reporting as a major component unit is considered to be essential to financial statement users.
2. There are significant transactions with the primary government.
3. There is a significant financial benefit or burden relationship with the primary government.

This clarification is congruent with Statement 34, which states “the focus of the government-wide financial statements should be on the primary government,” and “the notes should focus on the primary government” — noting the component units’ relationship to one another has little bearing on their relationship to the primary government and may actually distract from the focus of the primary government.

**Major Component Unit – Reporting**

Statement 61 clarifies the major component unit reporting requirements, noting they should be satisfied by any of the following:

1. Presenting each major component unit in a separate column in the reporting entity’s statements of net position and activities
2. Including combining statements of major component units in the reporting entity’s basic financial statements after the fund financial statements
3. Presenting condensed financial statements in the notes to the reporting entity’s financial statements

Nonmajor component units should continue to be aggregated in a single column. A combining statement for the nonmajor component units is not required but may be presented as supplementary information.

**Component Unit Blending Criteria**

One of the objectives of Statement 14 was to avoid obscuring the financial data of a primary government by inappropriately blending component unit data. Statement 61 amendments to the criteria for blending improve the focus of a financial reporting entity on the primary government by ensuring the primary government includes only those component units that are so intertwined with the primary government that they are essentially the same as the primary government. Statement 61 added additional provisions when the governing bodies are substantively the same and when a component unit’s total debt outstanding is expected to be paid with resources of the primary government.

**Governing Bodies Substantively the Same**

When the governing bodies are substantively the same, a component unit should be included in the reporting entity financial statements using the blended method when (a) a financial benefit or burden relationship exists between the primary government and the component unit, or (b) management of the primary government has operational responsibility for the component unit.

Management of a primary government has operational responsibility for a component unit if it manages the activities of the component unit in essentially the same manner it manages its own programs, department or agencies. Management of the primary government would need to have the ability to essentially affect the day-to-day operations of the component unit to the same extent it can affect the day-to-day operations of its own activities.
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Component Unit Debt Outstanding

When the component unit’s total debt outstanding, including leases, is expected to be repaid entirely or almost entirely with resources of the primary government, a component unit should be included using the blending method.

Exclusive Benefit Criterion

A component unit should be blended if it entirely or almost entirely serves or benefits the primary government—that is, the principal purpose of the component unit is to benefit the primary government and not provide services, either entirely or almost entirely, to those external to the government, such as its citizens. For example, a component unit providing internal services solely to the primary government would be blended with the primary government. In another example, a state lottery may have a significant financing relationship benefiting the primary government, but its services are provided entirely or almost entirely to the state’s citizenship, e.g., lottery players. In this instance, because the lottery players derive a benefit from the services provided, the component unit does not exclusively or almost exclusively serve or benefit the primary government.

Editor’s Note: Component units not blended are discretely presented. We anticipate that changes in the blending criteria will result in a number of component units previously blended under Statement 14 now being discretely presented under Statement 61.

Component Unit Blending – Reporting

Statement 61 amends and clarifies component unit financial reporting requirements in two areas concerning the blended concept:

- When a component unit is blended, the funds of the blended component unit assume all the characteristics of funds of the primary government and have the same financial reporting requirements as the primary government’s own funds. The general fund of a blended component unit continues to be reported as a special revenue fund as originally required in Statement 14.

- When the component unit information is blended by consolidating its financial data with that of a government engaged only in business-type activities that use a single column, condensed combining information is included in the notes to the financial statements—allowing users to better distinguish between the primary government and its component units. This does not preclude business-type activities from reporting a blended component unit in a separate column and presenting the combined primary government total column.

Equity Interest Reporting

Statement 14 originally provided that if an acquired enterprise met the criteria for reporting as a discretely presented component unit, the primary government reported the acquisition as an expense in economic resources-based financial statements, and no related asset or net assets of the acquired entity was reported. Conversely, Statement 14 required primary governments to report an asset for equity interests in joint ventures. Statement 61 ends this disparity and provides clarification to the existing guidance when the government’s intent for owning a majority equity interest is to directly enhance its ability to provide governmental services. Referring to the definition of an “asset” in Concepts Statement 4, “Elements of Financial Statements,” a primary government’s ownership of an equity interest in a discretely presented component unit should generally be recognized as an asset of the fund that has the equity interest (subject to reporting requirements for governmental funds), rather than as an expense or expenditure. The legally separate organization should continue to be reported as a component unit within the following criteria:
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- When such a component unit is blended, the purchase typically should be reported in the period of acquisition as an outflow of the primary government fund that provided the resources for the acquisition; in that and subsequent reporting periods, the primary government will report the component unit pursuant to the blending requirements in Statement 14, as amended.

- When the component unit is discretely presented, the equity interest in the net assets of the component units should be reported as an asset of the primary government fund that has the equity interest, subject to reporting requirements for governmental funds. If an optional total column for the reporting entity is presented, the equity interest would be eliminated and only the discretely presented component unit’s financial statement information would remain. As clarified by Statement 61, when such a component unit is discretely presented, changes in the equity interest should be reported pursuant to the “Reporting Participation in Joint Ventures in which There Is an Equity Interest” requirement in Statement 14, as amended, for both proprietary and governmental funds.

The new requirements for reporting equity interests in legally separate component units help ensure that primary government financial statements do not understate their financial position and provide for more consistent and understandable display of those equity interests. Statement 61 did not amend the requirement that a government’s purchase of corporate stock to obtain income or profit, rather than to directly enhance its ability to provide governmental services, should report its equity interest as an investment, regardless of the extent of ownership.

Minority Interests in Component Units & Related Organizations with Joint Venture Characteristics – Reporting

Statement 14, as amended, addresses the reporting of an organization with several participants that has the basic characteristics of a joint venture but is not under joint control because the organization’s relationship with one participant meets some aspect of the fiscal dependency criteria or one participating government appoints a voting majority of the organization’s governing body (and joint control is precluded because that participant has the power to make decisions unilaterally).

The amendments in Statement 61 require that under these circumstances, the organization itself, when included as a component unit in the majority participant’s financial reporting entity, should report any equity interests of the minority participants as fund balance “restricted net assets, nonexpendable” and not “reserved for minority interest” as originally required under Statement 14. Based on Statement 61 literature, this method is believed to be consistent with the concept that the equity interest’s use is constrained and should be included within restricted net assets in proprietary funds and in the governmentwide statement of net position.

Conclusion

GASB issues amendments to previously issued statements to improve financial reporting for a governmental financial reporting entity and increase the relevance of general purpose external financial reporting by state and local governments. Statement 61 allows financial statement users to better assess the accountability of elected officials by ensuring that the financial reporting entity includes only organizations for which the elected officials are financially accountable or that are determined by the government to be misleading to exclude.

Statement 61 is an amendment of the very comprehensive Statement No. 14, as amended by Statement 39, the objective of which is that all entities associated with a primary government are potential component units and should be evaluated for inclusion in the financial reporting entity.

Now is the time for governmental entities to begin re-evaluating every component unit against the inclusion and blending requirements born by Statement 61 and drafting notes describing the rationale for inclusion of component units, as well as the nature and effect of restatements caused by Statement 61, noting the following:
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- Changes made to comply with this statement should be treated as an adjustment of prior periods, and financial statements presented for the periods affected should be restated. 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, or fund equity or fund balance as appropriate, for the earliest period restated—generally the current period.

- Based on Statement 61 literature, GASB believes the effect of the new fiscal dependency criteria will be the exclusion of potential component units not related to the primary government through governing board appointments and whose relationships with the primary government, while not unimportant, are not sufficiently significant on their own to cause inclusion as a component unit.

- Regarding each discretely presented component unit, notes to the reporting entity’s financial statements should continue to include a brief description of each component unit, its relationships to the primary government, a discussion of management’s rationale for including the component unit and how these component units are reported. Determining which discretely presented component unit disclosures are essential to fair presentation is a matter of professional judgment and should be done individually for each component unit. A specific type of disclosure might be essential for one component unit but not for another depending on the individual component unit’s relationship with 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. For each major component unit, the notes should include a description of the nature and amount of significant transactions between the major component unit and the primary government.

- Based on Statement 14 and Statement 61 literature, notes should focus on the primary government, including its blended component units.

Diligence in preparing comprehensive and congruent footnotes and management discussion and analysis shows stakeholders that the government takes the financial reporting function seriously and has a strong set of internal controls over that process. Good governance makes good government, and planning ahead is a key to success. For more information on the new GASB statement, contact your BKD advisor.

This information was written by qualified, experienced BKD professionals, but applying specific information to your situation requires careful consideration of facts and circumstances. Consult your BKD advisor before acting on any matter covered here.