FSPSOP943A

LETTER OF COMMENT NO. 7

Dec 6

Mr. Russell G. Golden
Director of Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: File Reference Proposed FSP SOP 94-3a and AAG HCO-a

Dear Mr. Golden:

The Planning Subcommittee (PSC) of the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants is pleased to offer comments on the FASB's Exposure Draft of a proposed FASB Staff Position, *Omnibus Changes to Consolidation and Equity Method Guidance for Not-for-Profit Organizations.*

The PSC supports the Board's decision to provide guidance on the issues in the proposed FSP, and generally supports the proposed conclusions.

We have provided more specific comments in the attachments to this letter.

* * * * *

We appreciate the opportunity to comment on the proposed FSP. We are available to discuss our comments with Board members or staff at their convenience.

Sincerely,

Ben Neuhausen
Chairman
PSC

Richard Holt
Chair
NPO Omnibus FSP
Comment Letter Task
Force

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Attachment A

Question 1

Paragraph 19 of this FSP generally requires retrospective application of its provisions, except for provisions directly related to elimination of the temporary control exception to consolidation. What impediments, if any, do you anticipate in applying those provisions retrospectively? Please be specific.

Response - We are unaware of impediments to applying those provisions retrospectively.

Question 2

As indicated in footnote 2, this FSP would simplify the consolidation guidance in SOP 94-3 by deleting what the Board understands is a seldom, if ever, used provision in that guidance (and one that does not exist in the health care Guide)—"control through a majority ownership interest by other than ownership of a majority voting interest." If you know of any specific instances in which the relationships described in that provision exist, please describe them.

Response – We know of no specific instances in which the relationships described in that provision exist.

Attachment B - Comments on issues not specifically addressed in the Questions in the "Notice to Recipients"

Paragraph 1 – The ED provides as follows:

> Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, was amended by FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*, and applies to not-for-profit organizations through additional guidance provided by SOP 94-3 and the health care Guide.

That sentence implies that ARB 51 did not apply to NPOs prior to SOP 94-3. We believe that ARB 51 applied to NPO interests in for-profit entities prior to the issuance of SOP 94-3. We note that ARB 51 is included in Appendix C of SOP 94-2, as incorporated in Chapter 1 of the NPO Guide. As stated in paragraph 1.11 of the NPO Guide, pronouncements listed in Appendix C do not exempt not-for-profit organizations from their scope. We recommend the sentence be revised as follows:

> Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, was amended by FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*, and applies to not-for-profit organizations~~ through additional guidance provided by SOP 94-3 and the health care Guide~~.

Paragraph 8 – In some circumstances, a supermajority, rather than a simple majority, may be required to approve some or all board actions. For example, in circumstances in which a board has 5 members, the bylaws may stipulate that some or all board actions require approval by at least 4 of those 5 members. The existence of supermajority voting rights for some or all board actions could affect the determination of the controlling entity. Accordingly, we recommend that paragraph 8 be revised as follows (includes editorial comments):

> An organization generally shall be deemed to have a *majority voting interest in the board of another entity* if~~whenever~~ it has the direct or indirect ability to appoint individuals that together constitute a majority of the votes of the fully constituted board (that is, including any vacant board positions)~~.~~ needed to approve board actions. (Those individuals are not limited to the organization's own board members, employees, ~~and~~ or officers.) In some circumstances, however, certain actions

require approval by a supermajority vote of the board. Such voting requirements might overcome the presumption of control by the majority voting interest holder. Organizations should exercise judgment in evaluating such situations.*

*If a majority interest holder's inability to unilaterally approve certain board actions because of supermajority voting requirements exists -- for example, the requirement for a specified supermajority of the board to approve fundamental actions such as amending the articles of incorporation or dissolving the corporation – organizations should consider whether those voting requirements are akin to protective rights granted to minority stockholders (which typically would be insufficient to overcome the presumption of control) or instead, whether those voting requirements are of such significance that the presumption of control by the majority voting interest is overcome. The guidance in EITF Issue No. 96-16, *Investor's Accounting for an Investee When the Investor Has a Majority of the Voting interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights*, may be helpful in considering whether the inability of the majority voting interest to unilaterally approve certain actions due to supermajority voting requirements are substantial enough to overcome the presumption of control.

We recommend that similar changes be made to SOP 94-3 and the health care Guide to reflect the above comments.

Paragraph 9 –

As drafted, the proposed guidance does not necessarily describe the types of limitations that we believe should preclude consolidation. For example, a bond indenture is a contractual agreement that contains limitations, but in most cases the limitations would not be a type that we believe should preclude consolidation. In addition, laws may be other than state laws, such as foreign, federal or city laws. We note that paragraph 2 of ARB 51, *Consolidated Financial Statements*, provides that "...A majority owned subsidiary shall not be consolidated if control does not rest with the majority owners (as, for instance, if the subsidiary is in legal reorganization or in bankruptcy or operates under foreign exchange restrictions, controls, or other governmentally imposed uncertainties so severe that they cast

significant doubt on the parent's ability to control the subsidiary)." Accordingly, we believe the paragraph should be revised as follows:

> Sole corporate membership of one not-for-profit organization in another generally shall be considered a controlling financial interest unless ~~the sole corporate member's economic interest in the controlled entity is limited by state~~ law or contractual agreements impose limitations so severe that control does not rest with the sole corporate member.

Also, what are the exceptions to that "generally"? Is the only exception "unless the sole corporate member's economic interest in the controlled entity is limited by state law or contractual agreement," or do other exceptions exist?

Paragraph 10 - This table is confusing and not particularly helpful. We suggest the table be deleted. Because the table appears to be aimed at helping readers transition from the current guidance to the guidance in the FSP, we suggest revising the table to more closely align with the guidance in the FSP, revising the third column so that it informs readers about the effects the changes required by the FSP, and publishing the table either as an FASB staff article or as part of the AICPA's NPO Audit Risk Alert. If the table is retained in the FSP, we suggest moving it to an appendix.

Paragraph 11 – This paragraph mentions diversity in practice without explaining what practices are followed. The paragraph should describe the practices followed.

Paragraph 12 – Paragraph 12 should be revised to read as follows:

> ...Likewise, the "control" criterion that is a prerequisite for consolidation of ~~most~~ another not-for-profit organizations—defined by SOP 94-3 and the health care Guide as "the direct or indirect ability to determine the direction of management and policies through ownership, contract, or otherwise"—would arguably not be met for most relationships between not-for-profit lessees and not-for-profit SPE lessors.

Paragraph 13 – The status of EITF Topic D-14 unclear. It is therefore unclear whether the Board intends for NPOs applying the guidance in EITF Issue 90-15, *Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions,* to consider

whether any third parties that have made a substantive capital investment are independent of the NPO, because the incremental requirement that those third parties be independent appears only in Topic D-14 (and not in EITF 90-15).

Paragraph 13 provides as follows:

> Except for the rare instances in which the provision in paragraph 4(a) of Interpretation 46(R) applies to them, not-for-profit organizations shall apply the guidance in Issues 90-15, 96-21, and 97-1 whenever they are the lessees in transactions involving SPE lessors.

EITF Issue No. 90-15 provides that a lessee is required to consolidate a special-purpose entity lessor when certain conditions are all met. Included among those conditions is the following:

> The owner(s) of record of the SPE has not made an initial *substantive residual equity capital investment that is at risk* during the entire term of the lease.

EITF Topic D-14, which sets forth certain views of the SEC staff, provides as follows:

> Generally, the SEC staff believes that for nonconsolidation and sales recognition by the sponsor or transferor to be appropriate, the majority owner (or owners) of the SPE must be an *independent third party* [emphasis added] who has made a substantive capital investment in the SPE, has control of the SPE, and has substantive risks and rewards of ownership of the assets of the SPE (including residuals).

As stated previously, paragraph 13 of the proposed FSP does not mention Topic D-14. It is therefore unclear whether the Board intends for NPOs applying the guidance in EITF Issue 90-15 to consider whether any third parties that have made a substantive capital investment are independent of the NPO, because the incremental requirement that those third parties be independent appears only in Topic D-14 (and not in EITF 90-15). We observe that applying the guidance in EITF 90-15 without applying the related guidance in Topic D-14 may result in diversity in practice, and less consolidation than may be the Board's intent. We therefore suggest the Board clarify the applicability of Topic D-14 for NPOs that are applying the guidance in EITF 90-15. Specifically, we suggest that paragraph 13 of the

proposed FSP be revised to provide that NPOs should apply the guidance in Topic D-14.

In addition, the status of Question and Responses 1 through 9 in EITF 90-15, which represent SEC Staff positions on implementation questions relating to EITF 90-15, rather than consensus conclusions reached by the EITF, is unclear. We therefore suggest the Board clarify the applicability of Question and Responses 1 through 9 for NPOs that are applying the guidance in EITF 90-15. Specifically, we suggest that paragraph 13 of the proposed FSP be revised to provide that NPOs should apply guidance in Question and Responses 1 through 9.

In particular, we note that the proposed FSP is silent with respect to SPE transactions other than leasing transactions. We note that the Response to Question 2 of EITF 90-15 states the following:

> The views expressed by the SEC staff at the February and May 1989 EITF meetings [i.e. the views expressed in Topic D-14] are still applicable to SPE transactions other than those addressed by Issue 90-15. The SEC staff notes that the conditions identified in Issue 90-15 are consistent with the views on SPEs previously expressed by the SEC staff. The Issue 90-15 conditions focus on the risks and rewards and substantive nature of the SPE, which are critical to consolidation. Accordingly, the conditions set forth in Issue 90-15 may be useful in evaluating other transactions involving SPEs.

Because paragraph 13 of the proposed FSP instructs NPOs to apply Issue 90-15, we believe the Board should clarify that the conditions set forth in Issue 90-15 may be useful in evaluating SPE transactions other than leasing transactions. Further, our previous comment regarding the need for the Board to clarify the applicability of Topic D-14 also has implications in this regard, in that the response to Question 2 of EITF 90-15 incorporates by reference the views in Topic D-14 with respect to SPE transactions other than those addressed by Issue 90-15. Accordingly, we suggest that the proposed FSP explicitly state that NPOs should consider the guidance in Topic D-14 in considering whether nonleasing SPEs should be consolidated, and also that the guidance in Issue 90-15 may be useful in evaluating nonleasing SPE transactions.

Additionally, we note the following areas in which the unique characteristics of NPOs may necessitate additional clarification by the Board in order for NPOs to appropriately apply the guidance in Topic D-14.

- *Topic D-14 provides, among other things, that for nonconsolidation* and sales recognition by the sponsor or transferor to be appropriate, the majority owner (or owners) of the SPE must be an *independent third party.* NPOs sometimes use financially-interrelated but unconsolidated foundations to establish SPEs. It may be unclear whether those financially-interrelated but unconsolidated foundations are independent third parties with respect to the NPO. We believe that for purposes of determining whether an entity is an independent third party, the nature of a relationship between an NPO and a financially-interrelated but unconsolidated foundation is analogous to the relationship between an investor and an investee accounted for under the equity method. Further, we believe that in practice, investments made by an SPE sponsor's equity-method investee in the SPE are not deemed to be investments made by an independent third party for purposes of applying the guidance in Topic D-14. Similarly, we therefore believe that an investment by an unconsolidated foundation in an SPE sponsored by a financially-interrelated NPO would not be considered to be an investment by an independent third party for purposes of applying Topic D-14, and that the Board should explicitly state this. [We observe that NPOs and their financially-interrelated foundations typically are related parties. Though "all entities that are not related parties, (as defined in FAS 57)," is not necessarily a surrogate for "independent third party," in practice some have applied the literature by using "all entities that are not related parties, (as defined in FAS 57)," as a surrogate for "independent third party" and therefore concluded that financially-interrelated foundations are not independent third parties.]
- NPOs may seek to establish off-balance-sheet SPEs in which a substantial portion of the initial capital is provided by an individual or entity that otherwise would have contributed that capital to the NPO (referred to hereafter as a *friendly donor*), with that friendly donor receiving in exchange a residual interest in the SPE. Because that friendly donor provided capital to the SPE, rather than contributing to the NPO and the NPO subsequently investing in the SPE, some may believe the amount would not represent an investment that is at risk by a party independent of the NPO. We believe the FASB should provide guidance for determining whether and in what circumstances that friendly donor is considered an independent third party.

Paragraph 14 – Paragraph 14 provides as follows:

> The guidance in APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock,* applies to not-for-profit organizations other than health care providers through SOP 94-3, and to not-for-profit health care providers through guidance in Chapter 11 of the health care Guide.

That paragraph should be revised to acknowledge that paragraph 7 of SOP 94-3 includes an exception to the equity method in circumstances in which investments are reported at market value or fair value.

Paragraph 15 – Paragraph 15 provides as follows:

> Possibly because of the lack of clear guidance in this area in SOP 94-3, not-for-profit organizations within the scope of the AICPA Audit and Accounting Guide, *Not-for-Profit Organizations*, that choose to carry their "other investments" [FN omitted] at cost, rather than at fair value, generally do not use the equity method for their investments in for-profit partnerships, LLCs, or similar entities in which they have more than a minor interest. [FN omitted]

Rather than speculate on the reasons NPOs generally do not use the equity method for their investments in for-profit partnerships, LLCs, or similar entities in which they have more than a minor interest, we suggest deleting the lead-in to the sentence "possibly because of a lack of clear guidance in this area and SOP 94-3," because other reasons may exist why NPOs that choose to carry other investments at cost, rather than at fair value, generally do not use the equity method for their investments in for-profit partnerships, LLCs, or similar entities in which they have more than a minor interest. For example, some may believe that because the NPO Guide (category b GAAP in the GAAP hierarchy) was issued in 1996, and is silent pertaining to the applicability of SOP 78-9 (also category b GAAP in the GAAP hierarchy), that NPOs should not follow SOP 78-9. In addition, some may believe that because the NPO Guide is category b GAAP, guidance in the NPO Guide trumps the guidance in EITF pronouncements (category c GAAP) in circumstances in which the two conflict. We believe the FSP should state the fact that practice is to not use the equity method in these circumstances, but should not speculate on the reasons for that practice.

Paragraph 16 - The proposed FSP lists three specific pronouncements providing guidance on the use of the equity method (SOP 78-9, Issue 03-16, and FSP SOP 78-9-1). In order to make the FSP evergreen, the board should consider revising the paragraph to provide that NPOs apply authoritative pronouncements on use of the equity method of accounting to investments in for-profit partnerships, LLCs, or similar entities that constitute more than a minor interest (as defined in paragraph 8 of SOP 78-9) unless the NPO carries that investment at fair value or unless those pronouncements specifically exclude NPOs from their scope.

Paragraph 19 – We believe the transition provisions should require retrospective application unless it is impracticable. In circumstances in which retrospective application is impracticable, and the ED proposes prospective application, we support prospective application. That would provide more useful information and greater comparability, as well as avoiding undue hardship in circumstances in which organizations are unable to obtain the necessary information.

In addition, the transition provisions are difficult to follow. We suggest that the Board explain the reason for prospective application of paragraph 7, and paragraphs 8 and 9 in circumstances in which control is temporary.

Revised SOP and health care Guide - To the extent the amended SOP and/or health care Guide include guidance or wording that mirrors that in the conclusions section of the FSP, we have not repeated our comments on the amendments to those standards.

Revised SOP 94-3 Paragraph 14 – FN 4 – FN 4 to paragraph 14 provides as follows:

> While SOP 78-9 specifically addresses real estate partnerships and other ventures, in practice the guidance is used for similar entities in other industries by analogy. EITF Topic No. D-46, "Accounting for Limited Partnership Investments," notes that the SEC's staff position is that "investments in all limited partnerships should be accounted for pursuant to paragraph 8 of AICPA Statement of Position 78-9, *Accounting for Investments in Real Estate Ventures*."

Similar to practice as described above and to guidance followed by SEC registrants (but continuing to permit NPOs to use fair value reporting in certain circumstances), the FSP should require that investments in limited partnerships be accounted for pursuant to paragraph 8 of AICPA

Statement of Position 78-9 in circumstances in which they are not otherwise reported at fair value pursuant to GAAP.

Paragraph A1 – The proposed FSP includes various references to SOP 07-1, *Clarification of the Scope of the Audit and Accounting Guide* Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies.* The Board should revisit that guidance in light of its proposed FSP, SOP 07-1a, *Effective Date of AICPA Statement of Position 07-1.*

Amended SOP 94-3, Appendix D - Appendix D of SOP 94-3 includes flowcharts and decision trees. Those should be updated to reflect amendments made to the SOP.

Revised health care Guide - To the extent the health care Guide includes guidance or wording that mirrors that in SOP 94-3, we have not repeated our comments here.

Attachment C - Editorial Comments

FN 1 – Revise as follows:

> This FSP uses the term *related but separate not-for-profit organizations,* the term used in paragraph 1 of SOP 94-3, instead of *financially interrelated not-for-profit organizations,* because the latter term has a specific, narrower meaning in FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others.* Paragraphs A1(a) and A1(f) of this FSP amend the SOP to reflect this clarification.

Paragraph 3 – Revise as follows:

> In relationships between related but separate not-for-profit organizations [FN omitted] in which a controlling financial interest through majority ownership (or sole corporate membership for health care entities) does not exist, SOP 94-3 and the health care Guide require, permit, or prohibit consolidation depending on whether there is control, an economic interest, or both, and depending on the nature of the control. Consolidation is required if~~whenever there is~~ control exists via a majority voting interest in the board of another entity~~,~~ ~~if~~ and that majority voting interest is coupled with an economic interest (SOP 94-3, paragraph 11; health care Guide, paragraph 11.11). Consolidation is permitted but not required ~~whenever there is~~ if control exists via other means (such as by contract or affiliation agreement)~~,~~ and that control is ~~if~~ coupled with an economic interest (SOP 94-3, paragraph 12; health care Guide, paragraph 11.12). The existence of control or an economic interest, but not both, precludes ~~C~~consolidation ~~is prohibited whenever control and an economic interest both are not present~~ (SOP 94-3, paragraph 13; health care Guide, paragraph 11.13).

Paragraph 4 – Revise as follows:

> Conforming changes to reflect that amendment in the consolidations guidance in SOP 94-3 and the health care Guide were limited to paragraphs 5 and 10 of SOP 94-3 and

paragraph 11.10 of the health care Guide because those paragraphs ~~draw~~ directly apply the guidance in ARB 51 and provide that ~~upon~~ the existence of ~~usual condition of~~ a controlling financial interest through ownership of a majority voting interest requires consolidation~~that appears in ARB 51~~. Conversely, conforming changes to reflect that amendment were not made to the consolidation guidance in SOP 94-3 and the health care Guide that did not directly apply the guidance in ARB 51, such as the guidance in paragraphs 11 and 12 of SOP 94-3 and paragraphs 11.11. and 11.12 of the health care Guide.

Paragraph 6 – Revise as follows:

Questions have also arisen about the definition and example of *majority voting interest in the board of another entity* in SOP 94-3 and the health care Guide. Those questions center on (a) whether an organization has control by a majority voting interest in the board of another entity if it appoints board members who are other than its own board members, employees, or officers and (b) whether the organization has temporary control by a majority voting interest in the board of another entity when it cannot appoint a majority of the other organization's fully constituted board but, for a period of time, it appoints a majority of the filled board positions because of temporary vacancies on that board.

Paragraph 8 – We suggest the paragraph be revised as follows (Note: the following comment includes editorial comments. Substantive comments on this paragraph are made in Attachment B to this letter):

An organization shall be deemed to have a *majority voting interest in the board of another entity* ~~whenever~~ if it has the direct or indirect ability to appoint individuals that together constitute a majority of the votes of the fully constituted board (that is, including any vacant board positions), even if ~~. T~~those individuals are not ~~limited to~~ the organization's own board members, employees, ~~and~~ or officers.

We suggest changing "whenever" to "if" in order to avoid pushing entities toward the notion that subsidiaries should fall in and out of consolidation from year-to-year based on changing facts and circumstances (though in reality that may be the case).

Paragraph 11 – Revise as follows:

> FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities,* nullified Issue 90-15 and related guidance in Issues 96-21 and 97-1 for entities within its scope. Except in rare instances, not-for-profit organizations are excluded from the scope of Interpretation 46(R). [FN omitted] Thus, the otherwise nullified EITF guidance still applies to not-for-profit organizations~~them~~. Not-for-profit organizations, especially hospitals and universities, sometimes use leasing SPEs, including SPEs that would be deemed nonsubstantive in nature and require consolidation under the EITF guidance. However, there appears to be diversity in practice, possibly because of lack of awareness of, as well as some ambiguity about, the applicability of those EITF Issues.

Paragraphs 13 – We suggest changing "whenever" to "if" to avoid pushing entities toward the notion that they should fall in and out of certain accounting treatments from year-to-year based on changing facts and circumstances (though in reality that may be the case).

Paragraph 16 – Paragraph 16 should be revised as follows:

> Not-for-profit organizations shall apply the guidance on use of the equity method of accounting in SOP 78-9, Issue 03-16, and FSP SOP 78-9-1 ~~whenever the not-for-profit organization has an~~ to investments in ~~a~~ for-profit partnerships, LLCs, or similar entities~~y~~ that constitutes more than a minor interest (as defined in paragraph 8 of SOP 78-9) unless the not-for-profit organization carries that investment at fair value.