

Letter of Comment No: 27
File Reference: 1082-194R
Date Received: 5/25/99

May 24, 1999

Director of Research and Technical Activities
Financial Accounting Standards Board
401 Merritt 7, P.O. Box 5116
Norwalk, CT 06856-5116

File Reference No. 194-B

Dear Sir:

The Accounting Principles Committee of the Illinois CPA Society (the Committee) is pleased to comment on the proposed Statement of Financial Accounting Standards - Consolidated Financial Statements: Purpose and Policy. The organization and operating procedures of the Committee are reflected in the Appendix B to this letter. The following comments and considerations represent the collective views of the members of the Committee rather than any of the members of the Committee and of the organizations with which they are associated. Attached as Appendix A to this letter are comments from the Illinois CPA Society's Nonprofit Organizations Committee dealing with matters specific to the nonprofit industry.

The Committee supports the FASB in its efforts to provide guidance in the area of consolidation policy and agrees with the definition of control proposed in paragraph 6.a., when coupled with the majority voting interest described in paragraph 18a. of the exposure draft. However, the Committee disagrees with the proposed implementation guidance, specifically related to consolidation when a minority ownership exists. For example:

- Consolidating the financial statements of a 1% investment, as described in Example 3 in the implementation guidance, is misleading since 99% of the investee's assets and liabilities belong to the non-controlling minority.
- Consolidating the financial statements of an investee when a company only has an option to acquire a majority voting interest (as described in paragraph 18c.) is misleading because control does not truly exist until such option is exercised.

The Committee agrees with the position expressed in the Alternative View (paragraph 251) that control is not presumptive when a so-called controlling entity "has taken no action to attempt to effectuate a perceived ability to direct the policies and management of another entity".

The Committee also disagrees with the broad presumption in paragraph 8 of the exposure draft that consolidated financial statements are more meaningful than the separate statements of affiliated entities in situations where entities are consolidated with less than a majority ownership interest. The Committee believes that these are situations where partial or proportional consolidation, combined statements, the equity method of accounting or the cost method of accounting could be more appropriate than full consolidation.

The Committee is concerned that this proposal is being promulgated to catch up with changes adopted by the United Kingdom and by the International Accounting Standards Committee. The United States should be the leader in the setting of accounting standards, not a follower. Most other countries' accounting standards reflect their business practices, taxation methods, form of government and, in some cases, politics. United States accounting standards should not be conformed to reflect other countries methods of doing business.

Finally, the Committee opposes the proposed departure from the existing consolidation standards which are relatively objective. We believe that the subjectivity resulting will significantly reduce auditability and could result in an entity being consolidated one year and not the next year.

Very truly yours,

Richard H. Moseley, Chair
Accounting Principles Committee

Appendix A

The Illinois CPA Society's Nonprofit Organizations Committee (the Committee) is pleased to comment on the Proposed Statement on Financial Accounting Standards - *Consolidated Financial Statements: Purpose and Policy*.

The Committee in general supports the proposed Statement and believes that the results of operations and the financial position of a controlling nonprofit organization (parent) and controlled nonprofit organization (subsidiary) should be presented as if the group were a single organization with one or more divisions. The proposed statement would require that controlling organization must either have the means to increase its benefits and limit its losses through the decision making power that stem from the voting right or a right to share in the corporation's net assets upon dissolution, which might stem from provisions in the controlled corporation's articles of incorporation.

Relating to the exposure draft, the Committee has two areas of concern.

(1) The concept of what constitutes a "benefit" to a nonprofit organization is not clearly defined. We would ask the Board for examples of situations that would increase benefits to the controlling nonprofit organization.

(2) We are concerned about the effect of the proposed standards on accounting for split-interest agreements held by not-for-profit organizations with dual status as trustee-beneficiaries. If we are correct in our understanding of the application of the proposed standards and the implementation guidance in paragraphs 163-164, different types of split-interest agreements that we believe to be similar will be accounted for differently.

Under a split-interest agreement, a donor makes an initial transfer of assets to a not-for-profit organization and requires the not-for-profit organization to invest those assets and to make distributions to a beneficiary (or to itself) during the term of the agreement. At the end of the agreement, the remaining assets covered by the agreement are retained by the not-for-profit organization for its restricted or unrestricted use (or distributed to a beneficiary). The term "split-interest" is used because the interest in the assets covered by the agreement is split between two or more entities, usually into a lead (current or income) interest and a remainder (residual) interest.

Split-interest gifts held by not-for-profit organizations are in one of five forms: charitable gift annuities, charitable annuity trusts, charitable remainder unitrusts, charitable lead unitrusts, or pooled (life) income funds. Chapter 6 of the AICPA Audit and Accounting Guide, *Not-for-Profit Organizations*, currently provides the guidance for accounting for those agreements. In summary, the assets held under the agreements are recorded at their fair value when received. The contribution portion of the agreement (that is, the beneficial interest of the not-for-profit organization) is recognized at the time of the transfer as a contribution. The other beneficiary's interest is recognized as a liability incurred in what is considered the exchange portion of the transfer.

Appendix A

A *charitable gift annuity* is an arrangement between a donor and a not-for-profit organization in which the donor contributes assets to the organization in exchange for a promise by the organization to pay a fixed amount for a specified period of time to the donor or another entity specified by the donor. These agreements are not trusts, and it is our understanding that the accounting for a charitable gift annuity will not change as a result of the proposed standards. This type of agreement is discussed here because it is the simplest of the five forms of split interest agreements, and we can easily explain the accounting that we believe is appropriate for all split-interest agreements. In accordance with current guidance, the not-for-profit organization determines the term for which it is obligated to make payments to the annuitant (which is either spelled out or determined by reference to life-expectancy tables). It then computes the present value of the obligation to pay the fixed amount for that specified term. The present value of the annuity payments is reported as a liability, and the difference between the fair value of the assets transferred and the liability is reported as a contribution to the not-for-profit organization.

A *charitable annuity trust* is very similar to a charitable gift annuity. The difference is that the assets transferred by the donor are held in trust, and the not-for-profit organization's responsibility to make payments to the beneficiary ceases if the trust assets are depleted before the end of the term. (That seldom happens because one goal of the donor is to make a charitable contribution; there is generally a significant gift portion that would have to be depleted before payments terminated.) Currently, if the trust is held by the not-for-profit organization as trustee, the trust is accounted for in the same manner as the charitable gift annuity. If our understanding is correct, the accounting for a charitable annuity trust would change under the proposed standards, and would no longer be the same as the accounting for a charitable gift annuity.

By applying the thought process described in paragraphs 163–164 to the charitable annuity trust, we believe that the proposed standards would require that the trust be consolidated by the not-for-profit organization and the annuitant's beneficial interest would be reported as a minority interest rather than as a liability. The not-for-profit organization would control the trust because the not-for-profit organization's fiduciary duties as trustee would not preclude its investing trust assets for the purposes of increasing its benefits (residual interest) and limiting its losses from the activities of the trust (paragraph 164). The not-for-profit organization is not limited in its decision-making powers because, by investing to increase its residual interest, it invests in a manner favorable to the annuitant (whose fixed interest in the trust assets only requires that those assets not be depleted before the end of the term). We do not agree that the annuitant's beneficial interest should be reported as a minority interest by the not-for-profit organization, because the payment stream's fixed term and amount appear to meet the definition of a liability.

A *charitable remainder unitrust* differs from an annuity trust in that the amount to be paid to the beneficiary is expressed as a percentage of the fair value of the trust assets as determined annually rather than as a fixed amount. If our understanding is correct, the accounting for a charitable remainder unitrust would also change under the proposed standards, in the same way as described for the charitable annuity trust. The not-for-profit organization would control the trust because the not-for-profit organization's fiduciary duties as trustee would not

Appendix A

preclude its investing trust assets for the purposes of increasing its benefits (residual interest) and limiting its losses from the activities of the trust. The not-for-profit organization is not limited in its decision-making powers because, by investing to increase its residual interest, it invests in a manner favorable to the beneficiary (whose interest in the trust assets also grows as the trust assets increase). Although the beneficiary's interest in this case is more similar to a minority interest than the annuity trust (because the value of that interest varies as the trust assets increase and decrease), we do not believe that a charitable remainder unitrust differs so significantly from a gift annuity or an annuity trust that the accounting should be different.

Further, some charitable remainder unitrusts limit the annual payment to the beneficiary to the lesser of the stated percentage or the actual income earned. We are unclear whether that limitation on the not-for-profit organization's decision-making ability is significant enough to change the determination that the not-for-profit organization controls the trust. If it were, then it is our understanding that the not-for-profit organization would record only its residual interest in the trust assets, rather than record the assets it invests and a liability to the beneficiary (as is currently done) or the assets and the beneficiary's minority interest (as is proposed).

A *charitable lead unitrust* is similar to a charitable remainder unitrust except that the not-for-profit organization's interest and the beneficiary's interest are reversed. The not-for-profit organization receives a percentage of the assets each year and at the end of the term, the remaining assets are returned to the donor or to an entity specified by the donor. If our understanding is correct, the accounting for a charitable lead unitrust would also change under the proposed standards, in the same way as described for the charitable remainder unitrust. The not-for-profit organization would control the trust because the not-for-profit organization's fiduciary duties as trustee would not preclude its investing trust assets for the purposes of increasing its benefits (a percentage of the trust assets) and limiting its losses from the activities of the trust. The not-for-profit organization is not limited in its decision-making powers because, by investing to increase its lead interest, it invests in a manner favorable to the beneficiary (whose interest in the trust assets also grows as the trust assets increase). Although the beneficiary's interest in this case is more similar to a minority interest than the other agreements previously discussed (because it is a residual interest), we do not believe that a charitable lead unitrust differs so significantly from the other agreements that the accounting should be different.

A *pooled (life) income fund* differs from a charitable remainder unitrust agreement because the assets of many donors are pooled and invested as a group and the beneficiary specified by the donor receives the actual income earned on the units assigned to the assets transferred by the donor. A pooled (life) income fund is very similar to the agreement described in paragraph 163, and we conclude that the accounting would be the same as that described. That would be a change from the existing guidance because the not-for-profit organization would recognize only its remainder interest in the pool rather than all the assets under its management and a liability for the interests of the income beneficiaries. The proposed accounting would also differ from any of the other types of split-interest agreements.

Appendix A

Perhaps our determination of whether the not-for-profit organization's decision-making powers are limited is inconsistent with what the Board had intended. We are interpreting paragraph 164 to mean that decision-making powers are not limited if a not-for-profit organization can invest to increase its own interest and at the same time invest in a manner favorable to the beneficiary. We believe that is possible for all types of agreements described above except for pooled (life income) funds. A donor is limited in its ability to dictate the trust's investment policies because "a trust cannot qualify as a charitable remainder trust if there is any provision in the governing instrument that 'restricts the trustee from investing trust assets in a manner which could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets.'"¹ If a donor or individual beneficiary of a trust has control over the investment decisions made with respect to the trust or there are restrictions in the trust instrument on the manner in which the trustee may invest the trust assets, the tax status of the trust or the charitable deduction of the donor may be jeopardized.²

Further, not-for-profit organizations are permitted by the IRS to commingle the assets transferred under these agreements with their own assets and invest them as a group and they often do so.³ For all intents and purposes, those investments are fungible, and only the underlying accounting records identify them as held under split-interest agreements. (The underlying accounting records are similar to those of a mutual fund.) Although not-for-profit organizations may invest their split-interest agreements more conservatively than other investments, we do not think that is a limitation on their *power* to do otherwise. We view that conservative stance to be similar to a not-for-profit organization's decision to invest debt retirement funds more conservatively than its endowment, or to invest excess operating funds in money market instruments to avoid the risk that the value will be lesser when the funds are needed. If our understanding of paragraph 164 is incorrect, please provide additional clarification in the implementation guidance.

You could respond that our concerns about similar transactions being accounted for differently are unfounded because the differences in the agreements with the donor are significant enough that the accounting should differ. We would still be troubled by the characterization of the beneficiary's interests in the assets transferred under the split-interest agreements as minority interests. The beneficiaries' interests are neither interests in the net assets of the not-for-profit organization nor are they ownership interests in a separate legal entity. Instead, they are rights to cash flows from identifiable assets, and in many ways are more similar to a liability than an equity interest.

In conclusion, we ask the Board to consider further situations in which the trustee or the grantor is a beneficiary of a trust. Perhaps there is a way to justify consolidating split-interest trusts (or similar agreements that are not in trust form) but concluding that the beneficiaries' rights are liabilities rather than minority interests. The fact that the beneficiaries' rights are rights to cash flows that are both fixed or estimable and generated by identifiable assets may

¹ Regulation Section 1.664-2(a)(1)(iii) as quoted in *Tax Economics of Charitable Giving*, Arthur Andersen & Co., S.C., 1991.

² Revenue Ruling 83-19, 1983-1 C.B. 190

³ Letter Ruling 8303019

Appendix A

be helpful in distinguishing them from equity interests, which are more often residual interests in separate legal entities.

**ILLINOIS CPA SOCIETY
ACCOUNTING PRINCIPLES COMMITTEE
ORGANIZATION AND OPERATING PROCEDURES**

1998 - 1999

The Accounting Principles Committee of the Illinois CPA Society (the Committee) is composed of 29 technically qualified, experienced members appointed from industry, education and public accounting. These members have Committee service ranging from newly appointed to 15 years. The Committee is a senior technical committee of the Society and has been delegated the authority to issue written positions representing the Society on matters regarding the setting of accounting principles.

The Committee usually operates by assigning a subcommittee of its members to study and discuss fully exposure documents proposing additions to or revisions of accounting principles. The subcommittee ordinarily develops a proposed response which is considered, discussed and voted on by the full Committee. Support by the full Committee then results in the issuance of a formal response, which at times, includes a minority viewpoint.