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1/22/96

January 15, 1996

Financial Accounting Standards Board Mr. Timothy Lucas Director of Research and Technical Activities P.O. Box 5116 Norwalk, Connecticut 06856

Dear Mr. Lucas:

<u>File Reference 154-D</u> <u>Comments on Proposed Standard on Consolidated Financial Statements</u>

Comments Particularly Relevant to Not-for-Profit Organizations

I believe this is a good document. I do offer the following comments:

Par. 14 - Factors indicating (or not indicating) control

I suggest discussing (at least in the background material, if it is not desired to include this in the body of the document) some additional factors more often found in not-for-profits:

- overlapping board membership (specify a percentage?) (I realize this is probably implicit in the factor of controlling board selection, but people less familiar with the not-for-profit sector may not immediately realize this);
- being the sole (or substantial specify percentage?) funder of a charity; (I can see some argument that this is <u>not</u> an indicator of control because presumably the charity could develop other funding sources; if the Board would hold this view, then I urge it to say so explicitly.)
- indicating to funders of the "affiliate" that all funds raised will go to the "parent" (in the absence of legal or other effective control); I propose this is not an indicator of control under the proposed standard.
- if the affiliate qualifies as a "supporting organization" to another organization as defined in Internal Revenue Code Section 509(a)(3) (excerpts of related regulations attached), then consolidation should be required.

Par. 135 - Disclosure

I disagree with elimination of the requirement to have an accounting policy disclosure about consolidations. While admittedly less important than before, I believe that readers, especially of not-for-profit statements, should be able to quickly read that "all controlled not-for-profit and for-profit organizations are included in the statements" (or similar language.) In fact, I could argue that the use of the criterion of control rather than ownership is itself a change in accounting policy which calls for disclosure, at least for a few years until readers become used to it.

Par. 167 - Company foundations

I strongly disagree that a company does not ever control the assets of its company foundation. Although there are legal limitations on that control (see par. 12), I believe that those limitations are not so restrictive as to preclude control. In practice, although company foundations necessarily direct their charitable giving to eligible 501(c)(3) organizations, in most cases the selection of specific organizations, timing, and amounts is made by company management, or at the direction of company management, almost entirely to generate goodwill for the company in communities where it operates, sells, etc., or in certain cases like accounting firms, colleges where they recruit personnel. If that is not for the benefit of the company, I do not know what is. I admit that this is slightly short of the intent of par. 14-d, which says that to presume control, "... substantially all ... other future economic benefits [must accrue] to its creator." However, I think this is overcome by the presence of enough of the factors in par. 158 (a, c, e are present; (b, g, h, i are N/A); d and f are not present) to allow the conclusion that control is generally present in such relationships.

Par. 211 - Charitable trusts

I also disagree with the conclusion that a remainder trust would not be controlled. I think the limitations on the charity's freedom of action regarding the trust during its life are well within the range of acceptable limitations contemplated by FASB in par. 12, especially in light of the fact that it is completely assured that eventually the trust will pass fully into the charity's hands. (If it is not assured, then there is a condition, and the trust would not be recorded at all by the charity.) The limitations here are no worse than those on any restricted endowment fund owned by the charity. This item will also cause great problems for the exposure draft of the AICPA not-for-profit audit guide, which does effectively call for consolidation - and which was approved by FASB for exposure.

Since this paragraph talks about remainder trusts, it should also mention lead trusts.

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If I can provide further information about my views, please contact me at 703-641-5522.

Very truly yours,

Richard F. Larkin, CPA

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- (2) Section 509(a)(3)(A) provides that a section 509(a)(3) organization must be organized, and at all times thereafter operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified organizations described in section 509(a)(1) or (2). Section 509(a)(3)(A) describes the nature of the support or benefit which a section 509(a)(3) organization must provide to one or more section 509(a)(1) or (2) organizations. For purposes of section 509(a)(3)(A), paragraph (b) of this section generally described the organizational and operational tests; paragraph (c) of this section describes permissible purposes under the organizational test; paragraph (d) of this section describes the requirement of supporting or benefiting one or more "specified" publicly supported organizations; and paragraph (e) of this section describes permissible beneficiaries and activities under the operational test.
- (3) Section 509(a)(3)(B) provides that a section 509(a)(3) organization must be operated, supervised, or controlled by or in connection with one or more organizations described in section 509(a)(1) or (2). Section 509(a)(3)(B) and paragraph (f) of this section describe the nature of the relationship which must exist between the section 509(a)(3) and section 509(a)(1) or (2) organizations. For purposes of section 509(a)(3)(B), paragraph (g) of this section defines "operated, supervised, or controlled by"; paragraph (h) of this section defines "supervised or controlled in connection with;" and paragraph (i) of this section defines "operated in connection with."
- (4) Section 509(a)(3)(C) provides that a section 509(a)(3) organization must not be controlled directly or indirectly by disqualified persons (other than foundation managers or organizations described in section 509(a)(1) or (2)). Section 509(a)(3)(C) and paragraph (j) of this section prescribe a limitation on the control over the section 509(a)(3) organization.
- (5) For purposes of this section, the term "supporting organization" means either an organization described in section 509(a)(3) or an organization seeking section 509(a)(3) status, depending upon its context. For purposes of this section, the term "publicly supported organization" means an organization described in section 509(a)(1) or (2).
- (b) Organizational and operational tests. (1) Under subparagraph (A) of section 509(a)(3), in order to qualify as a supporting organization, an organization must be both organized and operated exclusively "for the benefit of, to perform the functions of, or to carry out the purposes of" (hereinafter referred to in this section as being organized and operated "to support or benefit") one or more specified publicly supported organizations. If an organization fails to meet either the organizational or the operational test, it cannot qualify as a supporting organization.
- (2) In the case of supporting organizations created prior to January 1, 1970, the organizational and operational tests shall apply as of January 1, 1970. Therefore, even though the original articles of organization did not limit its purposes to those required under section 509(a)(3)(A) and even though it operated before January 1, 1970, for some purpose other than those required under section 509(a)(3)(A), an organization will satisfy the organizational and operational tests, if, on January 1, 1970, and at all times thereafter, it is so constituted as to comply with these tests. For the special rules pertaining to the application of the organizational and operational tests to organizations terminating their private foundation status under the 12 sounth or 60-month termination period provided under section 507(b)(1)(B) by becom-'public" under section 509(a)(3), see the regulations under section 507(b).

- (c) Organizational test. (1) In general. An organization is organized exclusively for one or more of the purposes specified in section 509(a)(3)(A) only if its articles of organization (as defined in § 1.501(c)(3)-1(b)(2)):
- (i) Limit the purposes of such organization to one or more of the purposes set forth in section 509(a)(3)(A);
- (ii) Do not expressly empower the organization to engage in activities which are not in furtherance of the purposes referred to in subdivision (i) of this subparagraph;
- (iii) State the specified publicly supported organizations on whose behalf such organization is to be operated (within the meaning of paragraph (d) of this section); and
- (iv) Do not expressly empower the organization to operate to support or benefit any organization other than the specified publicly supported organizations referred to in subdivision (iii) of this subparagraph.
- (2) Purposes. In meeting the organizational test, the organization's purposes, as stated in its articles, may be as broad as, or more specific than, the purposes set forth in section 509(a)(3)(A). Therefore, an organization which, by the terms of its articles, is formed "for the benefit of" one or more specified publicly supported organizations shall, if it otherwise meets the other requirements of this paragraph, be considered to have met the organizational test. Similarly, articles which state that an organization is formed "to perform the publishing functions" of a specified university are sufficient to comply with the organizational test. An organization which is "operated, supervised, or controlled by" (within the meaning of paragraph (g) of this section) or "supervised or controlled in connection with" (within the meaning of paragraph (h) of this section) one or more sections 509(a)(1) or (2) organizations to carry out the purposes of such organizations, will be considered as meeting the requirements of this paragraph if the purposes set forth in its articles are similar to, but no broader than, the purposes set forth in the articles of its controlling section 509(a)(1) or (2) organizations. If, however, the organization by which it is operated, supervised, or controlled is a publicly supported section 501(c)(4), (5), or (6) organization (deemed to be a section 509(a)(2) organization for purposes of section 509(a)(3) under the provisions of section 509(a)), the supporting organization will be considered as meeting the requirements of this paragraph if its articles require it to carry on charitable, etc., activities within the meaning of section 170(c)(2).
- (3) Limitations. An organization is not organized exclusively for the purposes set forth in section 509(a)(3)(A) if its articles expressly permit it to operate to support or benefit any organization other than those specified publicly supported organizations referred to in subparagraph (1)(iii) of this paragraph. Thus, for example, an organization will not meet the organizational test under section 509(a)(3)(A) if its articles expressly empower it to pay over any part of its income to, or perform any service for, any organization other than those publicly supported organizations specified in its articles (within the meaning of paragraph (d) of this section). The fact that the actual operations of such organization have been exclusively for the benefit of the specified publicly supported organizations shall not be sufficient to permit it to meet the organizational test.
- (d) Specified organizations. (1) In general. In order to meet the requirements of section 509(a)(3)(A), an organization must be organized and operated exclusively to support or benefit one or more "specified" publicly supported organizations. The manner in which the publicly supported organizations must be "specified" in the articles for purposes of section 509(a)(3)(A) will depend upon whether the support-

charitable class benefitted by S. P would thus be considered as operating exclusively to support S within the meaning of section 509(a)(3)(A).

- (f) Nature of relationship required between organizations. (1) In general. Section 509(a)(3)(B) describes the nature of the relationship required between a section 501(c)(3) organization and one or more publicly supported organizations in order for such section 501(c)(3) organizations in order for such section 501(c)(3) organization to qualify under the provisions of section 509(a)(3). To meet the requirements of section 509(a)(3), an organization must be operated, supervised, or controlled by or in connection with one or more publicly supported organizations. If an organization does not stand in one of such relationships (as provided in this paragraph) to one or more publicly supported organizations, it is not an organization described in section 509(a)(3).
- (2) Types of relationships. Section 509(a)(3)(B) sets forth three different types of relationships, one of which must be met in order to meet the requirements of subparagraph (1) of this paragraph. Thus, a supporting organization may be:
 - (i) Operated, supervised, or controlled by,
 - (ii) Supervised or controlled in connection with, or
- (iii) Operated in connection with, one or more publicly supported organizations.
- (3) Requirements of relationships. Although more than one type of relationship may exist in any one case, any relationship described in section 509(a)(3)(B) must insure that:
- (i) The supporting organization will be responsive to the needs of demands of one or more publicly supported organizations; and
- (ii) The supporting organization will constitute an integral part of, or maintain a significant involvement in, the operations of one or more publicly supported organizations.
- (4) General description of relationships. In the case of supporting organizations which are "operated, supervised, or controlled by" one or more publicly supported organizations, the distinguishing feature of this type of relationship is the presence of a substantial degree of direction by the publicly supported organizations over the conduct of the supporting organization, as described in paragraph (g) of this section. In the case of supporting organizations which are "supervised or controlled in connection with" one or more publicly supported organizations, the distinguishing feature is the presence of common supervision or control among the governing bodies of all organizations involved, such as the presence of common directors, as described in paragraph (h) of this section. In the case of a supporting organization which is "operated in connection with" one or more publicly supported organizations, the distinguishing feature is that the supporting organization is responsive to, and significantly involved in the operations of, the publicly supported organization, as described in paragraph (i) of this section.
- (g) Meaning of "operated, supervised, or controlled by". (1)(i) Each of the items "operated by," "supervised by," and "controlled by," as used in section 509(a)(3)(B), presupposes a substantial degree of direction over the policies, programs, and activities of a supporting organization by one or more publicly supported organizations. The relationship required under any one of these terms is comparable to that of a parent and subsidiary, where the subsidiary is under the direction of, and accountable or responsible to, the parent organization. This relationship is established by the fact that a majority of the officers, directors, or trustees of the supporting organization are appointed or elected by the governing body, members of the governing body, officers acting

in their official capacity, or the membership of one or more publicly supported organizations.

- (ii) A supporting organization may be "operated, supervised, or controlled by" one or more publicly supported organizations within the meaning of section 509(a)(3)(B) even though its governing body is not comprised of representatives of the specified publicly supported organizations for whose benefit it is operated within the meaning of section 509(a)(3)(A). A supporting organization may be "operated, supervised, or controlled by" one or more publicly supported organizations (within the meaning of section 509(a)(3)(B)) and be operated "for the benefit of" one or more different publicly supported organizations (within the meaning of section 509(a)(3)(A)) only if it can be demonstrated that the purposes of the former organizations are carried out by benefitting the latter organizations.
- (2) The provisions of this paragraph may be illustrated by the following examples:

Example (1). X is a university press which is organized and operated as a nonstock educational corporation to perform the publishing and printing for M University, a publicly supported organization. Control of X is vested in a Board of Governors appointed by the Board of Trustees of M University upon the recommendation of the president of the university. X is considered to be operated, supervised, or controlled by M University within the meaning of section 509(a)(3)(B).

Example (2). Y Council was organized under the joint sponsorship of seven independent publicly supported organizations, each of which is dedicated to the advancement of knowledge in a particular field of social science. The sponsoring organizations organized Y Council as a means of pooling their ideas and resources for the attainment of common objectives, including the conducting of scholarly studies and formal discussions in various fields of social science. Under Y Council's by-laws, each of the seven sponsoring organizations elects three members to Y's board of trustees for 3-year terms. Y's board also includes the president of Y Council and eight other individuals elected at large by the board, Pursuant to policies established or approved by the board, Y Council engages in research, planning, and evaluation in the social sciences and sponsors or arranges conferences, seminars, and similar programs for scholars and social scientists. It carries out these activities through its own fulltime professional staff, through a part-time committee of scholars, and through grant recipients. Under the above circumstances, Y Council is subject to a substantial degree of direction by the sponsoring publicly supported organizations. It is therefore considered to be operated, supervised, or controlled by such sponsoring organizations within the meaning of section 509(a)(3)(B).

Example (3). Z is a charitable trust created by A in 1972. It has three trustees, all of whom are appointed by M University, a publicly supported organization. The trust was organized and is operated to pay over all of its net income for medical research to N, O, and P, each of which is specified in the trust, is a hospital described in section 509(a)(1), and is located in the same city as M. Members of M's biology department are permitted to use the research facilities of N, O, and P. Under subparagraph (1)(ii) of this paragraph, Z is considered to be operated, supervised, or controlled by M within the meaning of section 509(a)(3)(B), even though it is operated for the benefit of N, O, and P within the meaning of section 509(a)(3)(A).

Section 1

(h) Meaning of "supervised or controlled in connection with". (1) In order for a supporting organization to be "supervised or controlled in connection with" one or more pub-