

To: Board Members and David Bean
From: Paulina Haro, Blake Rodgers, Jialan Su, and Mitchell Harrison
cc: GASB Staff
Date: July 21, 2014
Re: Education Memorandum—Blending Requirements for Certain Business-Type Activities

INTRODUCTION AND BACKGROUND

The primary objective of the Blending Requirements for Certain Business-Type Activities (BTAs) pre-agenda research is to help identify which method of reporting component units for BTAs would best meet financial statement user needs. To achieve this objective, the project staff conducted the following research activities:

1. Reviewed relevant GASB literature, as well as literature from other standards-setting bodies
2. Examined annual financial reports of governments that report only BTAs
3. Solicited feedback from financial statement users focused on the healthcare and higher education sectors through a survey.

Four sections follow. The first section provides a summary of the relevant GASB literature and the literature from other standards-setting bodies. The second section provides the key questions that the research is intended to answer. The third section provides an overview of the approach to the study and the methodologies employed, as well as the limitations of the research design. The final section presents the results of research activities 2 and 3, outlined above, and the project staff's analysis of those results.

I. LITERATURE REVIEW

The project staff examined relevant GASB literature, as well as literature from the Financial Accounting Standards Board (FASB), the International Accounting Standards Board (IASB), the International Public Sector Accounting Standards Board (IPSASB), and the Federal Accounting Standards Advisory Board (FASAB). The discussion that follows summarizes the standards-setting bodies' approaches to including legally separate entities in the financial statements.

GASB Literature

Paragraphs 10–12 of Statement No. 14, *The Financial Reporting Entity*, as amended, define how GASB's standards approach the financial reporting entity (emphasis added).

10. **The concept underlying the definition of the financial reporting entity is that elected officials are accountable to their constituents for their actions.** Because one of the objectives of financial reporting is to provide users of financial statements with a basis for assessing the accountability of those elected officials, **the definition of the financial reporting entity should be based on accountability.** Because providing public services is, ultimately, the responsibility of elected officials, all governmental organizations are responsible to elected officials at the federal, state, or local level. **Financial reporting by a state or local government should report the elected officials' accountability for those organizations.**

11. **The financial statements of the reporting entity should allow users to distinguish between the primary government and its component units by communicating information about the component units and their relationships with the primary government rather than creating the perception that the primary government and all of its component units are one legal entity. To accomplish this goal, the reporting entity's government-wide financial statements should display information about the reporting**

government as a whole, using separate rows and columns to distinguish between the total primary government and its discretely presented component units. The reporting entity's fund financial statements should present the primary government's governmental, proprietary, and fiduciary funds (including its **blended component units, which are, in substance, part of the primary government**), reporting major funds individually and nonmajor funds in the aggregate. Component units that are fiduciary in nature should be reported only in the statements of fiduciary net position and changes in fiduciary net position with the primary government's fiduciary funds.

12. As discussed in detail below, **the financial reporting entity consists of the primary government and organizations for which the primary government is financially accountable** (see paragraphs 21–37). In addition, the primary government may determine through the exercise of management's professional judgment that the inclusion of an organization that does not meet the financial accountability criteria is necessary in order to prevent the reporting entity's financial statements from being misleading. In such circumstances, that organization should be included as a component unit (see paragraphs 39–41). The nucleus of a financial reporting entity usually is a primary government. However, a governmental organization other than a primary government (such as a component unit, a joint venture, a jointly governed organization, or another stand-alone government) serves as the nucleus for its own reporting entity when it issues separate financial reports. Although this section is written from the perspective of the primary government, its requirements apply to the separately issued basic financial statements of governmental component units, joint ventures, jointly governed organizations, and other stand-alone governments. These organizations should apply the provisions of this section as if they were a primary government.

Currently, Statement 14, as amended, requires that a legally separate entity be included as a component unit in a government's financial statements if any of the following three criteria are met:

- (1) The government appoints a voting majority of the legally separate entity's governing body and either:

- a. There is a financial benefit or burden relationship between the government and the legally separate entity, or
 - b. The government is able to impose its will on the legally separate entity.
- (2) The legally separate entity is fiscally dependent on the government and there is a financial benefit or burden relationship between the government and the legally separate entity.
- (3) The government believes that it would be misleading to exclude the legally separate entity from its financial statements.

Once a government determines that a legally separate entity should be included in its financial statements, Statement 14, as amended, prescribes how this component unit should be presented: either (a) in a separate column from the government (discrete presentation) or (b) combined with the government (blended presentation). A component unit should be blended with the government if any of the following three criteria are met:

- (1) The governing body of the government is substantively the same as the governing body of the component unit and either:
 - a. There is a financial benefit or burden relationship between the government and the component unit, or
 - b. Management of the government manages the activities of the component unit in the same or a similar manner in which it manages the government's activities.
- (2) The component unit provides services entirely, or almost entirely, to the government or otherwise exclusively, or almost exclusively, provides services indirectly to the primary government.
- (3) The component unit's total debt outstanding will be repaid entirely or almost entirely by resources from the government.

Component units that meet one of the criteria noted above are blended because they are so intertwined with the government that they are essentially the same as the government. All other component units are required by the current accounting and financial reporting standards to be discretely presented (presented in a separate column on the financial statements).

FASB Literature

General FASB Guidance

Topic 810 of the FASB Accounting Standards Codification (ASC) provides the objectives of consolidated reporting (emphasis added).

810-10-10-1 The purpose of consolidated financial statements is to present, primarily for the benefit of the owners and creditors of the parent, the results of operations and the financial position of a parent and all its subsidiaries as if the consolidated group were a single economic entity. **There is a presumption that consolidated financial statements are more meaningful than separate financial statements and that they are usually necessary for a fair presentation when one of the entities in the consolidated group directly or indirectly has a controlling financial interest in the other entities.**

Generally, all majority-owned subsidiaries—all entities in which a parent has a controlling financial interest—should be consolidated. A controlling financial interest is usually demonstrated through ownership of a voting majority interest; however, controlling financial interests may be achieved through arrangements that do not involve voting interests:

- **Variable Interest Entities (VIEs)**—A reporting entity has a controlling financial interest in a VIE if, based on the original design and structure of the VIE, the reporting entity has (1) the power to direct the activities of the VIE that most

significantly impact the VIE's economic performance and (2) the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE.

- **Entities Controlled by Contract**—A controlling financial interest exists if a contractual arrangement between the reporting entity and the controlled entity meets *all* of these requirements:
 - **Term**—The contract either has a finite period greater than 10 years or spans the remaining legal life of the controlled entity and is not terminable by the controlled entity.
 - **Control**—The reporting entity has exclusive authority over all decision making related to ongoing operations of the controlled entity and establishing guidelines for compensation and hiring and firing personnel.
 - **Financial Interest**—The reporting entity must have a significant financial interest in the controlled entity demonstrated through the reporting entity's ability to unilaterally sell or transfer its interest in the controlled entity and the reporting entity's ability to receive proceeds from the controlled entity fluctuates based on the performance of the controlled entity.

The guidance for entities controlled by contract is directed at the healthcare sector (physicians practices), but notes that it should be applied in other industries in which a contractual management arrangement is established under similar circumstances.

- **Research and Development Arrangements**—Subtopic 810-3o provides guidance on when a sponsoring entity should consolidate a newly created entity with an

infusion of cash and rights to certain technology of the sponsoring entity in exchange for common stock in the newly created entity.

FASB Guidance Specific to Not-For-Profit Entities

Subtopic 958-810 provides consolidation guidance specifically for not-for-profit (NFP) entities. The nature of the relationship between an NFP and another NFP entity determines the appropriate reporting. If an NFP has a controlling financial interest through direct or indirect ownership of a voting majority interest or sole corporate membership in another NFP, the controlling NFP generally should consolidate the other NFP entity. Sole corporate membership is considered equivalent to a majority voting interest and thus constitutes a controlling financial interest. Also, an NFP is considered to have a voting majority interest if it has the direct or indirect ability to appoint individuals that constitute a voting majority of the other NFP's board.

Control of another NFP may occur through means other than majority ownership interest, sole corporate membership, or majority voting interest in the board of the other entity. An NFP that has control through another means, such as a contract or affiliation agreement, is encouraged to consolidate another NFP if the NFP has an economic interest and consolidation would be meaningful. Also, subtopic 958-810 contains consolidation provisions for certain circumstances when an NFP is engaged in leasing transaction with a special-purpose lessor entity that substantially only leases to the NFP.

IASB Literature

International Financial Reporting Standard (IFRS) 10, *Consolidated Financial Statements*, requires an entity that is a parent (controls one or more entities) to present consolidated financial statements unless:

- The parent entity is a wholly- or partially-owned subsidiary and all owners (including nonvoting owners) have been informed about and do not object to the entity not presenting consolidated financial statements.
- The parent entity's debt or equity instruments are not traded in a public market.
- The parent entity has not filed nor is in the process of filing financial statements with a securities commission or other regulatory organization for the purposes of issuing instruments in a public market.

An entity (investor) controls another entity (investee) if the investor has power over the investee, exposure or rights to variable returns from its involvement with the investee, and the ability to use its power over the investee to affect the amount of the investor's returns. Power is the ability to direct the relevant activities, which are the activities that significantly affect the investor's returns. The assessment of power is based on the investor's rights and can be straightforward, such as when power over an investee is obtained through voting rights, or it can be more complex, such as when one or more contractual arrangements are involved. Paragraph B15 of IFRS 10 provides the following examples of rights that can give an investor power:

- Voting rights
- Rights to appoint, reassign, or remove members of the investee's key management personnel who have the ability to direct relevant activities
- Rights to appoint or remove another entity that directs relevant activities
- Rights to direct the investee to enter into, or veto any changes to, transactions for the benefit of the investor
- Decision-making rights specified in a management contract that give the holder the ability to direct relevant activities.

However, power is not equivalent to control. To have control, the investor must have the ability to use its power to affect the investor's returns from its investment with the investee.

IPSASB Literature

International Public Sector Accounting Standard (IPSAS) 6, *Consolidated and Separate Financial Statements*, provides guidance on when entities should be included in the economic entity. Paragraph 15 of IPSAS 6 provides that a controlling entity should "present consolidated financial statements in which it consolidates its controlled entities" unless:

- The controlling entity is wholly-owned and is unlikely to have user needs for its financial statements that are not met through its controlling entity's consolidated financial statements.
- The controlling entity's debt or equity instruments are not traded in a public market.
- The controlling entity has not filed, nor is in the process of filing, with a securities commission or other regulatory organization for the purpose of issuing instruments in a public market.
- Its controlling entity produces consolidated financial statements that comply with IPSASs and are available for public use.

The consolidated financial statements of the controlling entity should include all controlled entities unless there is evidence that the control is temporary because management intends to dissolve the controlled entity within 12 months and is actively seeking a buyer. Whether the controlling entity has control over the controlled entity is a matter of professional judgment. Control is defined in IPSASB's Glossary of Terms as

“the power to govern the financial and operating policies of another entity so as to benefit from its activities.” IPSAS 6 elaborates on the two elements of this definition: the power element and the benefit element. An entity must benefit from the activities *and* have the power to govern the financial and operating policies of another entity to be considered the controlling entity.

The Power Element

The power to govern the financial and operating policies of another entity does not necessarily require an entity to hold a majority shareholding or other equity interest in the other entity, nor does it require an entity to have responsibility for managing the day-to-day operations. The power to govern must be exercisable through legislation or some formal agreement. Paragraphs 39 and 40 of IPSAS 6 list the following power conditions that are indicative of or are likely to be indicative of control:

- Indicative of control
 - The entity has, directly or indirectly through controlled entities, ownership of a majority voting interest in the other entity.
 - The entity has the power, either granted by or exercised within existing legislation, to appoint or remove a majority of the members of the government body.
 - The entity has the power to cast, or regulate the casting of, a majority of the votes that are likely to be cast at a general meeting of the other entity.
 - The entity has the power to cast the majority of the votes at meetings of the governing body of the other entity.

- Likely to be indicative of control
 - The entity has the ability to veto operating and capital budgets of the other entity.
 - The entity has the ability to veto, overrule, or modify governing body decisions of the other entity.
 - The entity has the ability to approve the hiring, reassignment, and removal of key personnel of the other entity.
 - The mandate of the other entity is established and limited by legislation.
 - The entity holds special classes of shares in the other entity that confer rights to govern the financial and operating policies of that other entity.

The Benefit Element

The controlling entity needs to benefit from the activities of the other entity. These benefits could be financial or nonfinancial. Paragraphs 39 and 40 of IPSAS 6 list the following power conditions that are indicative of or are likely to be indicative of control:

- Indicative of control
 - The entity has the power to dissolve the other entity and obtain a significant level of the residual economic benefits or bear significant obligations.
 - The entity has the power to extract distributions of assets from the other entity or may be liable for certain obligations of the other entity.
- Likely to be indicative of control
 - The entity holds direct or indirect title to the net assets/equity of the other entity, with an ongoing right to access these.

- The entity has a right to a significant level of the net assets/equity of the other entity in the event of liquidation, or in a distribution other than liquidation.
- The entity is able to direct the other entity to cooperate with it in achieving its objectives.
- The entity is exposed to the residual liabilities of the other entity.

Current Project

It is important to note that the IPSASB is currently working on a project that could revise IPSAS 6. IPSASB issued Exposure Draft 49, *Consolidated Financial Statements*, in September 2013. The requirements are similar to current requirements in IPSAS 6. The significant changes are (1) providing a new definition of control, (2) addressing issues related to the consolidation of investment entities, and (3) removing the exception in IPSAS 6 that allows temporarily controlled entities to be excluded from the controlling entity's financial statement. The proposed definition is consistent with IFRS 10 and provides that control exists when an entity has all three of the following:

- Power over the other entity
- Exposure, or rights, to variable benefits from its involvement with the other entity
- The ability to use its power to affect the nature or amount of the benefits from its involvement with the other entity.

FASAB Literature

Statement of Federal Financial Accounting Concepts (SFFAC) 2, *Entity and Display*, provides guidance to federal entities on what should be included in the reporting entity.

Paragraph 40 of SFFAC 2 provides an explanation of the differences in reporting entity considerations between the GASB and the FASAB.

40. The Governmental Accounting Standards Board (GASB) has established criteria for what would be included in a state or local government reporting entity. These criteria relate to financial accountability, which includes appointment of a voting majority of the organization's governing board, together with imposition of will, and financial benefit to or burden on a primary government. These criteria, while in part relevant, must be tailored to the Federal Government environment. First, there are not as many different types of entities in the Federal Government as there are in state and local governments. Second, the Congress and others with oversight authority frequently establish explicit rules for what to include as part of a Federal reporting entity. Finally, as indicated, with the exception of the Federal Government as a whole, all the reporting units are components of a larger entity, namely the Federal Government, rather than independent economic entities.

The identification of entities that should be included in the reporting entity is based on two tiers of criteria: the conclusive criterion and the indicative criteria.

The Conclusive Criterion

Paragraphs 41 and 42 of SFFAC 2 provide that any entity that meets the conclusive criterion is part of the larger entity:

42. Appearance in the Federal budget section currently entitled "Federal Programs by Agency and Account" is a conclusive criterion. Any organization, program, or budget account, including off-budget accounts and government corporations, included in that section should be considered part of the U.S. Federal Government, as well as part of the organization with which it appears. This does not mean, however, that an appropriation that finances a subsidy to a non-Federal entity would, by itself, require the recipient to be included in the financial statements of the organization or program that expends the appropriation.

The Indicative Criteria

SFFAC 2 acknowledges that there are instances in which the conclusive criterion may result in the exclusion of entities that could result in misleading or incomplete financial statements and provides some criteria to inform judgment in these instances.

Paragraph 43 of SFFAC 2 points out that “[n]o single indicative criterion is a conclusive criterion. . . [n]or can weights be assigned to the indicative criteria.” The following indicative criteria from paragraph 44 of SFFAC 2 are listed in descending order of importance:

- The entity exercises any sovereign power of the government to carry out Federal functions. Evidence of sovereign powers are the power to collect compulsory payments (for example, taxes), use police powers, conduct negotiations involving the interests of the United States with other nations, or borrow funds for Government use.
- It is owned by the Federal Government, particularly if the ownership is of the organization and not just the property. Ownership is also established by considering who is at risk if the organization fails, or identifying for whom the organization’s employees work.
- It is subject to the direct or continuing administrative control of the reporting entity, as revealed by such features as:
 - The ability to select or remove the governing authority or the ability to designate management, particularly if there is to be a significant continuing relationship with the governing authority or management with respect to carrying out important public functions (in contrast to selections and designations in which there is little continuing communication with, or accountability to, the appointing official)

- Authority to review and modify or approve budget requests, budgetary adjustments, or amendments or rate or fee changes
 - Ability to veto, overrule, or modify governing body decisions or otherwise significantly influence normal operations
 - Authority to sign contracts as the contracting authority
 - Approval of hiring, reassignment, and removal of key personnel
 - Title to, ability to transfer title to, and/or exercise control over facilities and property
 - Right to require audits that do more than just support the granting of contracts. (While many of these criteria exist in a client-contractor relationship, it is not necessarily intended that an entity's contractor be considered as part of the reporting entity.)
- The entity carries out Federal missions and objectives.
 - The entity determines the outcome or disposition of matters affecting the recipients of services that the Federal Government provides.
 - It has a fiduciary relationship with a reporting entity, as indicated by such factors as the ability of a reporting entity to commit the other entity financially or control the collection and disbursement of funds; and other manifestations of financial interdependency, such as a reporting entity's responsibility for financing deficits, entitlement to surpluses (although not necessarily the assets acquired from failed units), or the guarantee of or "moral responsibility" for debt or other obligations.

II. RESEARCH QUESTIONS

The aims of this pre-agenda research were (1) to obtain information that will indicate which method of reporting component units for BTAs would best meet financial statement user needs and (2) to consider the need for revisions to existing standards. Specifically, this pre-agenda research intended to answer these questions:

- What types of component units currently are included in BTA financial statements and how are they being presented?
- What presentation of component units in BTA financial statements would provide the most useful information for making decisions and assessing accountability?

III. METHODOLOGY AND LIMITATIONS

Two research methods were employed to gather information on the presentation of component units in BTA financial statements: archival research and interviews with users. The preparation for conducting those research activities included conducting preliminary discussions with stakeholders.

Preliminary Discussions with Stakeholders

Potential issues that led to conducting research activities in this area were first brought to GASB's attention through discussions with stakeholders in the healthcare sector. To gain a deeper understanding of the issues surrounding the presentation of component units in BTA financial statements, preliminary information on the potential issues in the healthcare sector were obtained through conversations with an auditor stakeholder that were familiar with the topic, and through a liaison meeting with the Healthcare Financial Management Association's (HFMA's) Principles and Practices Board in April

2014. The focus was on the healthcare sector because of the prevalence of unique transactions in which this industry engages. Some of these unique transactions are “acquisitions”¹ of other entities, divestures of asset groups, or joint debt issuance (obligated groups). The discussion below summarizes major issues that were relevant to subsequent research efforts.

Acquisition of other entities

In many instances, a primary government will expand its service capacity by acquiring other incorporated, legally separate entities. The expansion is often accomplished by securing a voting majority of the new entity’s governing body or by becoming the sole corporate member of the new entity. Subsequent to the acquisition, the new entity does not dissolve its incorporation, but the governmental healthcare entity gains the ability to manage the operations of the acquired entity. One could argue that these acquired entities are legally controlled by the governmental healthcare entity even though they maintain their own separate legal status.

Divestures of assets

In different circumstances, the governmental healthcare entity may spin off a brand-new entity, transferring resources (assets, personnel, working capital, or related debt) and incorporating the service line into a new legally separate entity, while retaining sole corporate ownership.

¹ The term *acquire* (as well as the subsequent *acquired*, *acquiring*, and *acquisitions*) is in quotations because it is not used in this memorandum in the same manner that it is used in Statement No. 69, *Government Combinations and Disposals of Government Operations*. The joining of the legally separate entities is not done through a transaction that would be within the scope of Statement 69 because both entities continue to exist as legally separate entities.

These divested entities, as in the case of the acquired entities, often provide services under the same governmental healthcare management. In some instances, the primary government also commits to provide working capital for a period of time, until the spun-off entity is capable of generating those resources internally. In other cases, the primary government leases the capital assets to the new spun-off entity for a prolonged period of time. These newly created entities can be for-profit (in which case the BTA is usually the sole or majority shareholder) or not-for-profit (in which case the BTA may be sole corporate member or otherwise possess voting control of the entity's board).

Based on the criteria set forth in Statement 14, as amended, the entities discussed above generally will meet the criteria for inclusion in the reporting entity; however, they generally do not meet the criteria for blending. First, holding or appointing a voting majority of the governing body or being the sole corporate member or majority shareholder is not equivalent to having substantively the same governing body (paragraph 53a, as amended). Second, the main purpose of the entities discussed is to expand the governmental healthcare services by providing services to the general public, entities, or individuals other than the primary government and its employees (paragraph 53b, as amended). Finally, while it is possible that the primary government may have some responsibility for the total outstanding debt of the acquired or spun off entities, it is generally expected that those entities will generate sufficient resources to meet their own obligations and not impose a financial burden on the primary government (paragraph 53c).

Obligated Groups

Obligated groups are legally separate entities that, through the use of bond indenture, become jointly and severally liable for the issuance of specific debt. In the healthcare sector, the issuance of debt via obligated groups is quite common, given that there is a

primary government with one or multiple legally separate entities that can jointly repay the obligation. The formation of an obligated group allows the reporting entity to combine multiple business lines or assets to create a single entity (for debt issuance only) that becomes jointly and severally liable for debt. Obligated groups can be made up of all of the entities or a subset of the entities that comprise the reporting entity.

The stakeholders that participated in these discussions noted that users of financial statements are often interested in the obligated group for the purposes of their analyses and decision-making. Thus, many healthcare entities include supplemental schedules in their financial statements that provide consolidating financial information for the obligated group.

Focus of the Financial Statements

Paragraphs 13 and 14 of Statement 14 describe the primary government and emphasize that the primary government generally is the focus of the financial statements:

13. The foundation of a primary government is a separately elected governing body—one that is elected by the citizens in a general, popular election. As the nucleus of the financial reporting entity, the primary government generally is the focal point for the users of the financial statements. Thus, it is important to define the primary government and determine what it comprises. . .

14. *A primary government consists of all the organizations that make up its legal entity.* All funds, organizations, institutions, agencies, departments, and offices that are not legally separate are, for financial reporting purposes, part of a primary government. If an organization is part of a primary government, its financial data should be included with the financial data of the primary government.

Blended component units are included in the financial data of the primary government; however, discretely presented component units are excluded. The stakeholders that participated in these preliminary discussions expressed concerns that, in the

circumstance that a healthcare entity has “acquired” another entity through a means that does not meet the criteria for blending, the “acquired” entity would be discretely presented and, thus, removed from the focus of the financial statements—the primary government. Specifically, the concern expressed was that the primary government, in these cases, does not include these entities, which they believe are essentially carrying out the mission of the primary government. They also expressed their view that discrete presentation of these entities could be confusing for users of these financial statements because (1) the financial information is not fully consolidated, and (2) the method of presentation by governmental entities that follow the GASB’s standards differs from that of nongovernmental entities that follow the FASB’s standards. While governments are permitted to present a total reporting entity column with eliminations of activity between the primary government and its discretely presented component units, they are not required to do so. Thus, governments that do not present a total reporting entity column do not display consolidated information. Under the FASB’s standards, consolidated information presented in the financial statements generally would include these “acquired” entities.

Cash Flows Information

GASB Statement No. 34, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments*, does not require BTAs to present statements of cash flows for discretely presented component units. Question 2.4.3 in the Comprehensive Implementation Guide provides the specific guidance:

- 2.4.3. Q—A public university uses the business-type activities model and has a closely related fund-raising foundation that meets the component unit criteria in Statement No. 39, *Determining Whether Certain Organizations Are Component Units*. The foundation’s financial statements will be included through discrete presentation. Is the university required to

include the foundation's cash flow information in its statement of cash flows? (Q&A2003-2.3) [Amended 2012]

A—No. Paragraph 125 of Statement 34 states that the discrete presentation requirements are met by displaying component unit financial data in the statements of net position and activities. Even though that requirement is stated in terms that apply to reporting governmental activities, the standard should be comparably applied, in substance, to the business-type activities model. That is, component unit data should be included by discrete presentation in the statements of financial position (statement of net position/balance sheet) and changes in financial position (statement of revenues, expenses, and changes in net position). Paragraph 125 does not include a requirement to display component unit cash flow information.

However, cash flows information is required for blended component units that are presented as an enterprise fund. The stakeholders that participated in these preliminary discussions pointed out that, for a government that reports as a BTA, discrete presentation of a component unit can result in a lack of cash flows information for that component unit. Blended presentation would provide total cash flows information for the primary government and its blended component units, and the notes to the financial statements would include condensed cash flows information for each blended component unit.

Archival Research

The objectives of the archival research were to (1) examine the prevalence and presentation of component units in BTA reporting, (2) evaluate the criteria provided for the inclusion and presentation of the component units, (3) analyze the disclosure information provided, and (4) annotate the effects on component unit presentation, if any, that resulted from the implementation of Statement No. 61, *The Financial Reporting Entity: Omnibus*.

The project staff examined 81 financial reports randomly selected from specifically targeted population groups. The project staff concluded that it was important not only to ensure that the healthcare sector was represented in the sample, but also to include samples from the higher education sector, given the prevalence of component units in the financial reports of public colleges and universities. Finally, to ensure BTAs in general were represented, the project staff included a sample of special districts that report as BTAs. The project staff randomly selected large samples from all three sectors, with the expectations of obtaining at least 25 financial reports for each sector to conduct archival research. Seventy entities from the healthcare sector were randomly selected, and the project staff was able to obtain 26 financial reports. For the higher education sector, the project staff randomly selected 50 entities and was able to obtain 26 financial reports. Given the specific challenges of the special district sector (not all report only as BTAs) a random sample of 110 was selected and 29 financial reports were obtained. The challenge of obtaining the financial information is the result of several factors. Many entities are also component units of other governments and do not issue individual financial reports. Other entities may issue independent financial reports but that information is not readily available on their websites. The project staff also encountered entities that provided only non-GAAP financial reports on their websites.

Sampling

For a sample of healthcare entities, the project staff obtained the Census of Governments and segregated a population of 988 special districts by searching for the key words medical, hospital, or health. From that subset of special districts, the project staff obtained the most recent audited financial reports of 26 randomly selected healthcare entities. Fiscal year-ends ranged from June 30, 2012, through December 31, 2013.

To select the higher education entities, a list of public colleges and universities was obtained from the Integrated Postsecondary Education Data System (IPEDS) located on the National Center for Educational Statistics website.² The IPEDS list includes a separate entry for each campus within a university or college system; therefore, the project staff obtained the most recent audited financial reports for the system that includes the selected campus. No duplicate institutions from the same system were selected. The random sample of 26 colleges has fiscal year-ends ranging from June 30, 2012, through August 31, 2013.

For a sample of special districts that report only BTAs, the project staff employed a list of special districts that was prepared for the archival research being performed for the Financial Reporting Model Reexamination Pre-Agenda Research Project. The population from which the selections were made was the 89,526 governments included in the 2007 Census of Governments. The population was stratified by size using revenue data and the dollar thresholds for phase 1, 2, and 3 governments according to the effective date guidance in Statement 34. The most recent audited annual financial report was obtained for each of the 29 special districts randomly selected. Fiscal year-ends ranged from June 30, 2012, through August 31, 2013.

The annual financial reports were examined for: the inclusion of any component units; the rationale for including and presenting those component units; the effects, if any, of the implementation of Statement 61; and any additional information on these component units that was provided in the annual financial reports that exceeded the requirements of current standards.

² Accessed January 15, 2014.

User Survey

The purpose of the user research was to understand (1) what information about component units of BTAs that users need for their analyses and decision-making and (2) what presentation (blended or discrete) most appropriately provides them with that information. To obtain users' views, the project staff originally intended to conduct telephone interviews. However, low initial participation led to a subsequent round of requests to respond by email to the interview questions. As explained later in this section, four participants were interviewed by telephone and seven responded via email. Throughout this memorandum, the research will be referred to as the user survey.

A survey instrument was developed to elicit feedback on the importance of a BTA's component units to users' analyses, the reasons for their importance, and how the presentation of component units affects their analyses. (The interview protocol/survey questions can be found in Appendix A. A copy of the materials provided to participants in advance can be found in Appendix B.) The advance materials included two presentations (discrete and blended) of a sample healthcare system that has two community hospital component units. The materials and the protocol/survey were developed based on the provisions set for in the RTA manual..

The project staff originally chose to use interviews as a research method because this approach allows further exploration of answers provided by participants. Conducting interviews allows for direct follow-up questions based on the responses provided and can aid in understanding the underlying needs that lead to selection of one presentation over another. This can be particularly important for a complex or nuanced topic, such as the subject of this pre-agenda research.

Selection of Participants

The project staff originally invited 27 users—representing rating agencies, buy- and sell-side analysts, legislative fiscal offices, commercial banks, and credit enhancement organizations—to participate on April 3, 2014. The selected users were identified from their membership in the National Federation of Municipal Analysts (NFMA) and self-identification as specialists in either healthcare or higher education entities. Through follow-up interactions with some of these users and through the liaison meeting with HFMA’s Principles and Practices Board, an additional eight users were identified and invited to participate.

Four of the 35 invited users initially agreed to participate and were interviewed by telephone. Because of the low response, a second request was distributed, allowing for users to respond via email rather than participate in an interview. Although this resulted in losing the relative advantages of interviews, as previously described, it was considered necessary in order to increase the amount of user input.

The second request was sent by email on June 3, 2014, to 23 of the 35 users initially contacted—those who did not respond to the initial request. This invitation to participate also was sent to an additional 10 users identified by current and past members of the Governmental Accounting Standards Advisory Council (GASAC). A final reminder was sent by email on June 13, 2014, to 22 users who did not respond to the second request. In total, 45 users were invited to participate in the research. Of these, two responded that they did not analyze governmental entities, one had changed jobs and was unreachable, and a legislative analyst responded that he did not use financial statements leaving 41 viable invitations.

The second request and reminder generated an additional seven responses. Combined with the 4 interviews, a total of 11 responses were received from the 41 viable invitations to participate. This constitutes a response rate of 26.8 percent. Table 1 summarizes the invitations extended and accepted by type of user. This rate is favorable compared with recent GASB research with users: research with users of business-type entity financial statements for the fiduciary responsibilities project produced a response of 8.6 percent; a survey of users identified as healthcare or higher education specialists on irrevocable charitable trusts produced a response of 5.1 percent. However, considering the narrow focus of the subject matter and the targeted nature of the users included in the sample, project staff might have hoped for a higher response rate.

Table 1
Responses to Invitations to Participate by User Type

User Type	Number of Invitations Extended	Number of Responses	Response Rate
Rating agencies	7	1	14.3%
Buy-side: mutual fund	4	0	0.0%
Buy-side: wealth management	7	2	28.6%
Buy-side: insurance investor	2	0	0.0%
Sell-side analysts	11	4	36.4%
Legislative fiscal offices	3	0	0.0%
Credit enhancement	4	3	75.0%
Other bond market	3	1	33.3%
Total	41	11	26.8%

Limitations of Methodologies

There are some limitations to both the archival research and user interviews. Specific efforts were made to ensure that the healthcare and education sectors were amply represented. Although the entities reviewed were randomly selected, the approach to developing the population was targeted to these two sectors. The sample for special districts was designed to achieve a broader representation of additional BTA sectors. Nevertheless, this sample cannot be generalized to the broader population.

A variety of types of users were invited to participate in the survey. Efforts were made to select participants representing different kinds of entities within each of the types of users. Nevertheless, the participants were not selected using a completely random process, nor were the findings statistically tested. Therefore, the results of the research may be representative of the views of the larger population of users but are not strictly generalizable.

IV. RESULTS AND ANALYSIS

Archival Research

The project staff analyzed annual financial statement information of higher education entities, special districts reporting only BTAs, and healthcare entities in an attempt to gather data on current practices. For each entity, the project staff noted whether the financial reporting entity included component units, the number of component units included and their presentation (discrete or blended), the reporting entity's rationale provided for blended or discrete presentation and disclosures, whether the reporting entity has implemented Statement 61 and its impact, and the purpose and size (with

respect to net position) of the component units included in the reporting entity if possible.

From this research, several themes emerged that will be highlighted in more detail:

- The use of discrete presentation was more prevalent in the higher education arena and blended presentation was more common in healthcare.
 - The blended component units of most healthcare entities and all housing authorities included in the review are limited liability corporations (LLCs) that carry out the mission of the government.
 - Blended component units in the healthcare represent a large percentage of net position with respect to the reporting entity.
- The disclosure of an entity's rationale for blended presentation frequently failed to meet the requirements of the standards.
 - Furthermore, most governments reviewed failed to provide required disclosures for their blended component units (in other words, condensed financial information).
 - Also, in the higher education sector, the aggregation of large numbers of component units presents a challenge for the reporting entity.
- Implementation of Statement 61 has not necessarily resolved this issue of failing to properly meet the disclosure requirements.

Prevalence of Component Units

Table 2 summarizes the presentation of component units by type of entity. Note that, because entities can present both discrete and blended component units, the percentages may exceed 100 percent. There were 90 blended component units and 190 discretely presented component units in the 44 BTAs that reported component units.

This table highlights the prevalence of discrete presentation in higher education and blended presentation in healthcare. Very few of the special districts reviewed include component units in their financial reports. The three special districts that reported component units were housing authorities.

Table 2
Form of Component Unit Presentation by Entity Type
(n=81)

Form of Presentation	Higher Education (n=26)		Special District BTAs (n=29)		Healthcare (n=26)		Total	
	%	n	%	n	%	n	%	n
Discrete	73%	19	0%	0	35%	9	35%	28
Blended	50%	13	10%	3	50%	13	36%	59
No component units	15%	4	90%	26	27%	7	46%	37

Sector Analysis

The project staff analyzed the notes to the financial statements of each entity's annual financial report to identify the rationale disclosed for each component unit inclusion and presentation in the reporting entity. Though the specific explanations vary, the entities in each of the three groups showed general themes discussed independently below. These reporting entities did not always fully justify the inclusion of legally separate entities as component units, as outlined in Statement No. 39, *Determining Whether Certain Organizations are Component Units*. Statement 39 requires that legally separate, tax-exempt organizations be discretely presented in the financial statements if all the following criteria are met:

1. "The economic resources received or held by the separate organization are entirely or almost entirely for the 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 (footnote omitted).
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.”

Therefore the project staff assumed that if those component units were discretely presented, the inclusion would be, in general, appropriate. Furthermore, it was assumed that if disclosures stated that the primary government appointed a voting majority of the governing body of the component unit, and it was feasible to assume that the component unit provided services exclusively or almost exclusively to the primary government, it was acceptable to blend those component units. Finally, it should be noted that a large number of financial reports provided insufficient information to draw a conclusion of whether the component unit should have been blended or discretely presented; therefore, the information will be discussed as ‘inconclusive’ for those that failed to provide sufficient justification.

Higher Education Entities

The higher education sector was subdivided into three subgroups: those presenting only discrete component units, those presenting only blended component units, and those presenting both blended and discrete component units. Although one government included a research foundation and another included a property management component unit, in the first subgroup (those presenting only discrete component units), nine higher education governments only included discretely presented component units, the majority of which were fundraising foundations. The net position of these discretely presented component units represented, on average, 19

percent of the net position of the reporting entity, ranging between 2.2 and 55 percent of net position.

The second subgroup (those presenting only blended component units) included three higher education governments who presented only blended component units. Two of them adequately justified the blending of their component units. The first government stated that the primary government retained control over the foundation and endowment association (entities assumed to provide exclusive service to the government).

The second government provided adequate criteria for the inclusion of 17 component units in its financial report (Statement 39 guidance) and adequately justified the blending of these component units by stating that the component units provide services almost entirely to the university (Statement 61 guidance). The third government justified blending a student facilities corporation based on a “fiscal dependency” argument and attempted to justify the argument by stating that the component unit (which follows FASB guidance) represented 34 percent of total assets, 66 percent of liabilities, and 3 percent of revenues with respect of the reporting entity.

From the third subgroup (those presenting both blended and discrete component units), 8 of the 10 higher education governments blended their component units by stating (or implying) that the component units provided services almost exclusively to the government. The remaining three governments with blended component units provided insufficient rationale to evaluate the component unit presentation. One entity stated that it blended a housing authority to “comply with GASB requirements,” while the other two cited incomplete criteria (common management, financial dependence, sole beneficiary of resources held).

Healthcare Entities

The health care group was subdivided into two subgroups. The first subgroup includes six entities that reported discretely presented component units only. As with the higher education sector, the project staff assumed that the inclusion of the discretely presented component units was “adequate,” in general, although only two reporting entities properly justified the inclusion of legally separate entities in their financial reports. Four of these entities reported foundations with net position representing less than 5 percent of the reporting entity’s net position. The fifth entity included in its financial statements an ambulatory center and an imaging center, both incorporated as LLCs. Both LLCs represented less than 1 percent of the reporting entity’s net position. The sixth entity reported a foundation and a hospital corporation. The hospital represented 99 percent of the reporting entity’s revenues and its net position are larger than the reporting entity’s total (the entity has negative net position).

In the second subgroup of health care entities, all entities included either only blended component units (10 governments) or a combination of blended and discretely presented component units (3 governments). The justification for inclusion of the discretely presented component units was not always complete, although it might appear appropriate to include them in the reporting entity. These discretely presented component units had very little net position and revenues with respect to the reporting entity.

These 13 healthcare entities included 33 blended component units in their financial reports. A significant trend in the healthcare sector was the inclusion of LLCs as component units (25 LLCs were included in the sample). The primary government identified LLCs by directly stating their status or by asserting sole corporate membership or ownership of the primary government. These LLCs generally

constituted large segments of the operations of the healthcare entities. Some were holding corporations for the hospital segment, or ambulatory services, while other LLCs were created for physicians or nurse groups. In general, these LLCs did not provide services directly to the government, but rather serviced the citizenry of the government.

Special Districts

The three special districts that reported component units were housing authorities that presented, in total, 12 blended component units. One housing authority attempted to apply the blending criteria in Statement 61 by stating that the boards of the primary government and the component unit were the same, but the complementary criterion was insufficiently explained as “the entities are intertwined.” This entity provided consolidated information for the combination of three blended component units, but no individual component unit information was provided.

The second housing authority blended eight component units with the justification that the component units are “in substance, part of the authority.” This entity provided detailed supplementary financial information for each of its eight blended LLCs in and stated that it implemented Statement 61 without any modifications. Five of these blended component units hold further ownership in other LLCs for the purpose of housing development.

The third authority blended one component unit, a not-for-profit corporation, by stating that the component unit comprises the same board as the authority and that the component unit utilizes staff from the authority. This government commented on the implementation (or future implementation) of eight separate Statements beginning with Statement No. 60, *Accounting and Financial Reporting for Service Concession*

Arrangements, but provided no commentary on the status of Statement 61. This housing authority included detailed supplementary financial information of its blended component unit.

The same pattern of component unit inclusion as in the healthcare sector was observed in this very small sample of housing authorities. LLCs were created with the government as sole corporate member that operated specific business segments of the primary government.

User Survey

The results of the user survey are summarized below regarding user needs for a BTA's presentation of component unit information. Respondents discussed the importance of component unit information in their decision-making process and their preferences for the presentation of component unit information. The surveys concluded with a discussion of each respondent's ideal presentation structure.

Importance of Information about BTA Component Units

Users were first asked to rate the importance of financial information about the component units of BTAs to their decisions and analyses. The respondents clearly found component unit financial information to be important to their decisions or analyses. Table 3 summarizes the results.

Table 3
Importance of Financial Information about Component Units of
BTAs
(n=11)

	Percentage of All Respondents	Number
Very important	55%	6
Somewhat important	36%	4
Total important	91%	10
Somewhat Unimportant	9%	1
Not important at all	0%	0
Total unimportant	9%	1
Do not know/uncertain	0%	0
All respondents	100%	11

When asked why they believed that information about the component units of BTAs were important to their decisions and analyses, the respondents mentioned several considerations. Five respondents noted the importance of information about intra-entity transactions, for which understanding the support provided between the primary government and the component units was the driving factor for their opinion. Four respondents shared that their opinion was solely based on the significance of the component units in relationship to the primary government (one of these respondents specifically focused on the significance of the revenues of the component unit to the primary government).

Five respondents also discussed the importance of debt obligations and how they would introduce a burden relationship between component units and the primary government. Specifically, a respondent stated that when performing analyses on the primary government, if the component unit had no debt or was obligated for its own debt with no recourse to the primary government, the information about that component unit would only be important to assess its financial position. In addition,

information on the component unit would be important if the primary government would provide resources to the component unit if the component unit was not performing well.

All respondents stressed that the importance of a component unit to their analyses may vary based on the relationship of the component unit to the primary government, the significance of the component unit to the primary government, and the focus and purpose of their analyses. Thus, as discussed below, many believe that it is important to see each component units both separately and consolidated so that they can exclude or include component units based on their needs.

Preferred Presentation of BTA Component Units

Respondents were asked to select between two sample presentation formats. Illustration 1 (refer to the materials in the appendices to this memorandum) utilized discrete presentation to display component unit information, while Illustration 2 utilized blended presentation.

All of the respondents who selected Illustration 1 cited the value of analyzing component unit information separately while maintaining the option to make their own adjustments or consolidations. These respondents also preferred a full set of financial statements for component units over the condensed information in Illustration 2. Three of the four respondents who selected Illustration 2 did so because of the importance of a total column. These respondents discussed that if Illustration 1 provided a total or consolidated column and eliminations, their preference would likely change to Illustration 1. The remaining respondent specifically cited Illustration 2 as preferable because it provides the same information as Illustration 1 and includes

additional cash flow information, an important component of that respondent's analyses. Table 4 summarizes the results.

Table 4
Preferred Presentation Format
(n=11)

	Percentage of All Respondents	Number
Illustration 1 (Discrete)	64%	7
Illustration 2 (Blended)	36%	4
All Respondents	100%	11

Additional Comments

Respondents were given the opportunity to provide additional comments or feedback. The project staff noted a common theme in the discussion with the respondents. All would like to see complete component unit financial information separately presented somewhere in the financial statements. In addition, most (seven respondents) would like to have a total reporting entity column or presentation that consolidates the entire reporting entity. This presentation would make it easier, in their view, to perform any adjustments they consider necessary.

Several respondents mentioned that condensed financial information was often too summarized for their needs. One respondent specifically mentioned a preference for the brevity of Illustration 2, but the condensed financial information was too summarized for their needs. As an example, this respondent mentioned a desire to analyze an accounts receivable trend which cannot be accomplished via the condensed information. Three respondents also mentioned the possible inclusion of some sort of consolidating schedule that highlighted the interaction between all of the entities. In summary, respondent feedback indicates a preference for a presentation format that

includes individual component unit information as well as a consolidated total (with consolidated eliminations).

Appendix A: User Interview/Survey Protocol and Materials

Blending Requirements for Certain Governments Engaged Only in Business-Type Activities Interview Protocol: [name and organization]

Thank you for agreeing to be interviewed. Before we begin, I should mention that it is our usual practice to record interviews for later reference. The recording will be used for internal GASB purposes only and will not be shared with anyone outside of the GASB or its parent organization, the Financial Accounting Foundation. Is this okay with you?

Did you have an opportunity to review the materials that we sent you in advance?

[If they say no] Would you prefer to arrange a different time for this interview after you have had an opportunity to review the materials?

[If they say yes] Good. Then let's begin with the questions.

Questions

1. On a scale of 1 to 5, with 1 being not important at all and 5 being very important, how important or unimportant is financial information about the component units of BTAs to the decisions you make or the analyses you perform?

Not important
at all

Very
important

1

2

3

4

5

[If they answered 3, 4, or 5] Why is that information important?

[If they answered 1 or 2] Why is that information not important?

2. Which illustration in Attachment A is more useful to the decisions you make or the analyses you would perform regarding the Health System and its component units:

- a. Illustration 1
- b. Illustration 2

3. [*If they answered Illustration 1*] Why do you consider Illustration 1 more useful than Illustration 2?

[*If they answered Illustration 2*] Why do you consider Illustration 2 more useful than Illustration 1?

[*If they did not choose one of the Illustrations*] What elements of each illustration do you consider most useful?

Thank you very much for participating! We know your time is valuable and appreciate your taking the time today to provide us your feedback.

ILLUSTRATION 1: DISCRETE PRESENTATION OF COMMUNITY HOSPITALS

Illustration 1a

**HEALTH SYSTEM
STATEMENT OF NET POSITION
AS OF DECEMBER 31, 2014
(Amounts in Thousands)**

	Primary Government Health System	Component Units*
ASSETS		
Current assets		
Cash and cash equivalents	\$ -	\$ 11,934
Investments	-	31,344
Assets limited as to use	40,123	-
Ad valorem taxes receivable, less allowances for uncollectible taxes of \$10,520	1,285	-
Patient accounts receivable, less allowances of \$410,577	74,102	86,406
Due from affiliates	1,256	5,412
Other receivables	202,043	1,574
Inventories and other assets	10,266	-
Total current assets	<u>329,075</u>	<u>136,670</u>
Capital assets—net	954,865	157,864
Assets limited as to use	455,010	176,809
Other noncurrent assets	34,012	5,539
Total assets	<u>1,772,962</u>	<u>476,882</u>
LIABILITIES		
Current liabilities		
Accounts payable and accrued expenses	145,998	12,515
Due to affiliates	-	6,426
Due to third-party reimbursement programs	10,477	-
Current portion of long-term debt	6,000	1,405
Interest payable	3,559	776
Other current liabilities	16,484	5,532
Total current liabilities	<u>182,518</u>	<u>26,654</u>
Other long-term liabilities	22,539	-
Long-term debt	801,245	23,149
Total liabilities	<u>1,006,302</u>	<u>49,803</u>
NET POSITION		
Net investment in capital assets	147,620	133,310
Restricted	491,574	207,377
Unrestricted	127,466	86,392
Total net position	<u>\$ 766,660</u>	<u>\$ 427,079</u>

See accompanying notes to financial statements.

*Governments are required to present information about each *major* component unit in one of three ways:

- a. Separate presentation on the face of the basic financial statements
- b. Combining statements presented after the basic financial statements
- c. Condensed financial statements in the notes to the financial statements

In the example, the government believes that both discretely presented component units are major and has elected to present condensed financial statements in the notes to the financial statements. See Illustration 1d. Note that the government is not required to present information on the statement of cash flows for major discretely presented component units.

Illustration 1b

HEALTH SYSTEM
STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET POSITION
FOR THE YEAR ENDED DECEMBER 31, 2014
(Amounts in Thousands)

	Primary Government Health System	Component Units*
OPERATING REVENUES		
Net patient services	\$ 471,226	\$ 277,104
Government subsidies	195,655	-
Other, net	74,102	74,234
Total operating revenues	<u>740,983</u>	<u>351,338</u>
OPERATING EXPENSES		
Salaries, wages, and benefits	744,029	187,451
Purchased medical services	88,544	12,444
Supplies and other	300,289	88,934
Pharmaceuticals	111,604	25,497
Depreciation and amortization	49,784	8,231
Total operating expenses	<u>1,294,250</u>	<u>322,557</u>
Operating (loss) income	<u>(553,267)</u>	<u>28,781</u>
NONOPERATING REVENUES (EXPENSES)		
Ad valorem tax support	487,106	-
Grants and contributions	54,118	2,784
Investment income	10,289	248
Interest expense	(13,499)	(698)
Total nonoperating revenues and expenses	<u>538,014</u>	<u>2,334</u>
Income before capital contributions	(15,253)	31,115
Capital contributions	<u>52,698</u>	<u>150</u>
Change in net position	<u>37,445</u>	<u>31,265</u>
Net position—beginning of year	<u>729,215</u>	<u>395,814</u>
Net position—end of year	<u>\$ 766,660</u>	<u>\$ 427,079</u>

See accompanying notes to financial statements.

*Governments are required to present information about each *major* component unit in one of three

- a. Separate presentation on the face of the basic financial statements
- b. Combining statements presented after the basic financial statements
- c. Condensed financial statements in the notes to the financial statements

In the example, the government believes that both discretely presented component units are major and has elected to present condensed financial statements in the notes to the financial statements. See Illustration 1d. Note that the government is not required to present information on the statement of cash flows for major discretely presented component units.

Illustration 1c

**HEALTH SYSTEM
STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED DECEMBER 31, 2014
(Amounts in Thousands)**

	Primary Government Health System*
CASH FLOWS FROM OPERATING ACTIVITIES:	
Receipts from third-party payors and patients	\$ 478,969
Payments to suppliers	(502,744)
Payments to employees	(740,125)
Other receipts	155,402
Net cash used in operating activities	<u>(608,498)</u>
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES:	
Ad valorem taxes	491,521
Grants and contributions	17,990
Net cash provided by noncapital financing activities	<u>509,511</u>
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES:	
Capital contribution	52,689
Purchases of capital assets	(247,978)
Interest paid	(45,710)
Net cash used in capital and related financing activities	<u>(240,999)</u>
CASH FLOWS FROM INVESTING ACTIVITIES:	
Interest received	13,498
Purchases of investments	(312,811)
Maturities and sales of investments	602,883
Net cash provided by investing activities	<u>303,570</u>
DECREASE IN CASH AND CASH EQUIVALENTS	(36,416)
CASH AND CASH EQUIVALENTS—Beginning of year	<u>245,154</u>
CASH AND CASH EQUIVALENTS—End of year	<u>\$ 208,738</u>

(Continued)

* Cash flow statements are not required for discretely presented component units.

Illustration 1c

**HEALTH SYSTEM
STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED DECEMBER 31, 2014
(Amounts in Thousands)**

	Primary Government Health System*
RECONCILIATION OF OPERATING LOSS TO NET CASH USED IN OPERATING ACTIVITIES:	
Operating loss	\$ (553,267)
Adjustments to reconcile operating loss to net cash used in operating activities:	
Depreciation and amortization	49,784
Change in operating assets and liabilities:	
Patient accounts receivable	(3,598)
Other receivables, inventories, and other assets	(32,484)
Due from affiliates	(7,411)
Accounts payable and accrued expenses	(76,874)
Due to third-party reimbursement programs	5,091
Other current liabilities	475
Net pension asset	9,861
Other long-term liabilities	(75)
Net cash used in operating activities	<u>\$ (608,498)</u>
NONCASH ITEMS	
Purchases of capital assets in accounts payable and accrued expenses	\$ 13,598
Unrealized loss on investments	\$ (5,789)
RECONCILIATION OF CASH AND CASH EQUIVALENTS	
Cash and cash equivalents on the statement of net position	\$ -
Cash and cash equivalents included in assets limited as to use	208,738
Total cash and cash equivalents	<u>\$ 208,738</u>

See accompanying notes to financial statements.

(Concluded)

* Cash flow statements are not required for discretely presented component units.

Illustration 1d

Note X: Condensed Financial Information for Discretely Presented Component Units

The condensed financial information for Community Hospital A and Community Hospital B is presented below as of and for the year ended December 31, 2014.

	Community Hospital A	Community Hospital B
Assets		
Current assets	\$ 97,113	\$ 39,557
Capital assets, net	105,243	52,621
Other assets	97,845	84,503
Liabilities		
Current liabilities	(22,888)	(3,766)
Long-term liabilities	(23,149)	-
Net position		
Net investment in capital assets	82,094	52,621
Restricted	95,664	110,308
Unrestricted	76,406	9,986
Total net position	\$ <u>254,164</u>	\$ <u>172,915</u>
Operating revenues		
Net patient services	\$ 189,002	\$ 88,102
Other operating revenues	57,491	16,743
Operating expenses		
Depreciation and amortization	(5,488)	(2,743)
Other operating expenses	(224,465)	(89,861)
Operating income	16,540	12,241
Nonoperating revenues (expenses)	2,177	157
Capital contributions	140	10
Change in net position	18,857	12,408
Beginning net position	235,307	160,507
Ending net position	\$ <u>254,164</u>	\$ <u>172,915</u>

ILLUSTRATION 2: BLENDED PRESENTATION OF COMMUNITY HOSPITALS

Illustration 2a

**HEALTH SYSTEM
STATEMENT OF NET POSITION
AS OF DECEMBER 31, 2014
(Amounts in Thousands)**

	Primary Government Health System
ASSETS	
Current assets	
Cash and cash equivalents	\$ 11,934
Investments	31,344
Assets limited as to use	40,123
Ad valorem taxes receivable, less allowances for uncollectible taxes of \$10,520	1,285
Patient accounts receivable, less allowances of \$410,577	160,508
Due from affiliates	6,668
Other receivables	203,617
Inventories and other assets	10,266
Total current assets	465,745
Capital assets—net	1,112,729
Assets limited as to use	631,819
Other noncurrent assets	39,551
Total assets	2,249,844
LIABILITIES	
Current liabilities	
Accounts payable and accrued expenses	158,513
Due to affiliates	6,426
Due to third-party reimbursement programs	10,477
Current portion of long-term debt	7,405
Interest payable	4,335
Other current liabilities	22,016
Total current liabilities	209,172
Other long-term liabilities	22,539
Long-term debt	824,394
Total liabilities	1,056,105
NET POSITION	
Net investment in capital assets	280,930
Restricted	698,951
Unrestricted	213,858
Total net position	\$ 1,193,739

See accompanying notes to financial statements.

Illustration 2b

HEALTH SYSTEM
STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET POSITION
FOR THE YEAR ENDED DECEMBER 31, 2014
(Amounts in Thousands)

	Primary Government Health System
OPERATING REVENUES	
Net patient services	\$ 748,330
Government subsidies	195,655
Other, net	148,336
Total operating revenues	<u>1,092,321</u>
OPERATING EXPENSES	
Salaries, wages, and benefits	931,480
Purchased medical services	100,988
Supplies and other	389,223
Pharmaceuticals	137,101
Depreciation and amortization	58,015
Total operating expenses	<u>1,616,807</u>
Operating (loss) income	<u>(524,486)</u>
NONOPERATING REVENUES (EXPENSES)	
Ad valorem tax support	487,106
Grants and contributions	56,902
Investment income	10,537
Interest expense	(14,197)
Total nonoperating revenues and expenses	<u>540,348</u>
Income before capital contributions	15,862
Capital contributions	<u>52,848</u>
Change in net position	68,710
Net position—beginning of year	1,125,029
Net position—end of year	<u>\$ 1,193,739</u>

See accompanying notes to financial statements.

Illustration 2c

**HEALTH SYSTEM
STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED DECEMBER 31, 2014
(Amounts in Thousands)**

	Primary Government Health System
CASH FLOWS FROM OPERATING ACTIVITIES:	
Receipts from third-party payors and patients	\$ 765,412
Payments to suppliers	(598,451)
Payments to employees	(947,711)
Other receipts	203,061
Net cash used in operating activities	<u>(577,689)</u>
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES:	
Ad valorem taxes	491,521
Grants and contributions	52,174
Net cash provided by noncapital financing activities	<u>543,695</u>
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES:	
Capital contribution	52,848
Purchases of capital assets	(409,883)
Interest paid	(16,075)
Net cash used in capital and related financing activities	<u>(373,110)</u>
CASH FLOWS FROM INVESTING ACTIVITIES:	
Interest received	14,752
Purchases of investments	(578,410)
Maturities and sales of investments	865,874
Net cash provided by investing activities	<u>302,216</u>
DECREASE IN CASH AND CASH EQUIVALENTS	(104,888)
CASH AND CASH EQUIVALENTS—Beginning of year	<u>470,244</u>
CASH AND CASH EQUIVALENTS—End of year	<u>\$ 365,356</u>

(Continued)

Illustration 2c

**HEALTH SYSTEM
STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED DECEMBER 31, 2014
(Amounts in Thousands)**

	Primary Government Health System
RECONCILIATION OF OPERATING LOSS TO NET CASH USED IN OPERATING ACTIVITIES:	
Operating loss	\$ (524,486)
Adjustments to reconcile operating loss to net cash used in operating activities:	
Depreciation and amortization	58,015
Change in operating assets and liabilities:	
Patient accounts receivable	(6,748)
Other receivables, inventories, and other assets	(39,474)
Due from affiliates	(5,430)
Accounts payable and accrued expenses	(74,874)
Due to third-party reimbursement programs	5,091
Other current liabilities	498
Net pension asset	9,800
Other long-term liabilities	(81)
Net cash used in operating activities	<u>\$ (577,689)</u>
NONCASH ITEMS	
Purchases of capital assets in accounts payable and accrued expenses	\$ 24,715
Unrealized loss on investments	\$ (7,741)
RECONCILIATION OF CASH AND CASH EQUIVALENTS	
Cash and cash equivalents on the statement of net position	\$ 11,934
Cash and cash equivalents included in assets limited as to use	<u>351,102</u>
Total cash and cash equivalents	<u>\$ 363,036</u>

See accompanying notes to financial statements.

(Concluded)

Illustration 2d

Note X: Condensed Financial Information for Blended Component Units

The condensed financial information for Community Hospital A and Community Hospital B is presented below as of and for the year ended December 31, 2014.

	Community Hospital A	Community Hospital B
Assets		
Current assets	\$ 97,113	\$ 39,557
Capital assets, net	105,243	52,621
Other assets	97,845	84,503
Liabilities		
Current liabilities	(22,888)	(3,766)
Long-term liabilities	(23,149)	-
Net position		
Net investment in capital assets	82,094	52,621
Restricted	95,664	110,308
Unrestricted	76,406	9,986
Total net position	<u>\$ 254,164</u>	<u>\$ 172,915</u>
Operating revenues		
Net patient services	\$ 189,002	\$ 88,102
Other operating revenues	57,491	16,743
Operating expenses		
Depreciation and amortization	(5,488)	(2,743)
Other operating expenses	<u>(224,465)</u>	<u>(89,861)</u>
Operating income	16,540	12,241
Nonoperating revenues (expenses)	2,177	157
Capital contributions	<u>140</u>	<u>10</u>
Change in net position	18,857	12,408
Beginning net position	235,307	160,507
Ending net position	<u>\$ 254,164</u>	<u>\$ 172,915</u>
Net cash provided by:		
Operating activities	\$ (10,683)	\$ (5,114)
Noncapital financing activities	-	-
Capital and related financing activities	(49,154)	-
Investing activities	34,986	17,564
Beginning cash and cash equivalents	42,415	15,020
Ending cash and cash equivalents	17,564	27,470

Appendix B: Materials Provided to User Interview/Survey Participants

Blending Requirements for Certain Governments Engaged Only in Business-Type Activities

Thank you for agreeing to provide feedback on the GASB's current pre-agenda research activities on blending requirements for certain governments engaged only in business-type activities (BTAs). We are seeking your feedback on the value to your analysis and decision making of information provided in BTA financial statements relating to certain entities that are legally separate from the BTA, but are included in its financial statements.

To help you provide this feedback, we have included the questions that we will ask you during the scheduled telephone interview to assist you in preparing for our discussion.

We look forward to speaking with you.

Background

The GASB currently is researching the application of its standards that establish how certain legally separate entities are presented in a BTA's financial statements.

Current Guidance

Including a Legally Separate Entity

Currently, standards require that a legally separate entity be included as a *component unit* in a BTA's financial statements if any of the following three criteria are met:

- (1) The BTA appoints a voting majority of the legally separate entity's governing body *and* either:

- a. There is a financial benefit or burden relationship between the BTA and the legally separate entity, *or*
- b. The BTA is able to impose its will on the legally separate entity.

OR

- (2) The legally separate entity is fiscally *dependent*³ on the BTA and there is a financial benefit or burden relationship between the BTA and the legally separate entity.

OR

- (3) The BTA believes that it would be misleading to exclude the legally separate entity from its financial statements.

Presenting a Legally Separate Entity

Once it is determined that a legally separate entity should be included in a BTA's financial statements, standards prescribe how this component unit should be presented in the BTA's financial statements: either (a) in a separate column from the BTA (*discrete* presentation) or (b) combined with the BTA (*blended* presentation).

Based on the current accounting and financial reporting standards, a component unit should be *blended* with the BTA, if any of the following three criteria are met:

- (1) The governing body of the BTA is substantively the same as the governing body of the component unit *and* either:
 - a. There is a financial benefit or burden relationship between the BTA and the component unit, *or*
 - b. Management of the BTA manages the activities of the component unit in the same or a similar manner in which it manages the BTA's activities.

OR

³ An legally separate entity is fiscally *dependent* on a BTA if it requires the BTA's approval to do any of the following: issue debt, pass a budget, or set taxes (if applicable) or rates/charges.

(2) The component unit provides services entirely or almost entirely to the BTA.

OR

(3) The component unit's total debt outstanding will be repaid entirely or almost entirely by resources from the BTA.

Component units that meet one of the criteria noted above are blended because they are so intertwined with the BTA that they are essentially the same as the BTA. All other component units are required by the current accounting and financial reporting standards to be discretely presented (presented in a separate column on the financial statements).

Subject of the GASB's Research

Because BTAs are business-like in their operations, there are BTAs whose relationship with a component unit is such that they may have legal control over the component unit but the component unit does not meet the criteria to be blended with the BTA's financial information for financial statement presentation.

For example, assume that a BTA, the Health System, expands its operations by gaining the ability to appoint a voting majority of both community hospitals' governing bodies and the ability to remove members of those governing body at will. Based on the current accounting and financial reporting standards, the community hospitals would meet the criteria to be included in the Health System's financial statements as component units because of the Health System's ability to appoint a voting majority of the governing bodies and remove members of the governing body at will.

The Health System appoints the majority of the community hospitals' governing bodies, but the governing bodies are not substantively the same as the Health System's governing body. Further, the community hospitals provide services to entities other than the Health System and the community hospitals' outstanding debt is secured and paid entirely by a pledge of each community hospital's own revenues. Based on these facts and the current accounting and financial reporting standards, the community hospitals would be presented in a separate, discrete column on the financial statements rather than consolidated with the financial information of the Health System.

To illustrate the difference between blended and discrete presentation, Attachment A to this document provides two illustrations of the Health System.

In Illustration 1, the Health System includes two discretely presented component units—the Community Hospital A and Community Hospital B. The financial statements in Illustration 1 are accompanied by a note that presents the condensed financial information for each discretely presented component unit; however, governments have the option to present the financial information for major discretely presented component units separately on the face of the financial statements or in combining statements.

Illustration 2 provides an example of the financial statements for the same Health System with the community hospitals *as if they were required to be presented as blended component units*. The financial statements presented in Illustration 2 are accompanied by a required note disclosure that includes the condensed financial information of the community hospitals.