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Heads Up

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A Tale of Two Standards

FASB Clarifies and Amends Consolidation and Equity Method Guidance for Not-for-Profit Organizations

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Introduction and Scope

The FASB's new Staff Position (FSP) No. SOP 94-3-1 and AAG HCO-1, "Omnibus Changes to Consolidation and Equity Method Guidance for Not-for-Profit Organizations," makes several changes to the consolidation and equity method guidance applicable to not-for-profit organizations, including nongovernmental health care organizations. The FSP also amends SOP 94-3[1] and the Health Care Guide[2] ("the Guide") to clarify their application and eliminate conflicts between their guidance and ARB 51.[3]

In addition to making some conforming changes to the concept of a sole corporate member, the FSP (1) clarifies the definition of control through a majority voting interest, (2) eliminates the exception to consolidation when control is expected to be temporary, (3) confirms the applicability of Issues 90-15,[4] 96-21,[5] and 97-1[6] to transactions with special-purpose entity (SPE) lessors, and (4) requires the equity method be applied to certain investments in for-profit partnerships, LLCs, and similar entities unless they are reported at fair value.

Effective for fiscal years (and interim periods) beginning after June 15, 2008, the FSP is to be applied **prospectively** to all relationships, arrangements, and interests that exist on the effective date. If application of the FSP results in an entity changing its accounting (e.g., a change from the cost method to the equity method of accounting for investments in for-profit partnerships), a cumulative change adjustment to the relationships, arrangements, and interests is required as of the date the FSP is adopted.

The FSP is intended only to address conflicts in existing literature and eliminate uncertainty about the applicability of the consolidation and equity method guidance in SOP 94-3, the Guide, and Issues 90-15, 96-21, and 97-1. Accordingly, the FSP does not comprehensively change the guidance on accounting and reporting by not-for-profit organizations for interests in other entities.

1 AICPA Statement of Position 94-3, *Reporting of Related Entities by Not-for-Profit Organizations.*
2 AICPA Audit and Accounting Guide *Health Care Organizations.*
3 Accounting Research Bulletin No. 51, *Consolidated Financial Statements.*
4 EITF Issue No. 90-15, "Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions."
5 EITF Issue No. 96-21, "Implementation Issues in Accounting for Leasing Transactions Involving Special-Purpose Entities."
6 EITF Issue No. 97-1, "Implementation Issues in Accounting for Lease Transactions, Including Those Involving Special-Purpose Entities."

Sole Corporate Membership

Both SOP 94-3 and the Guide require consolidation if a not-for-profit organization has a controlling financial interest in another entity. Under ARB 51, a controlling financial interest is commonly established by either direct or indirect ownership of a majority voting interest in another entity (unless control does not rest with the majority interest holder). The definition of a controlling financial interest under the Guide includes sole corporate membership in addition to a majority ownership interest.[7] The Guide defines a sole corporate member as a not-for-profit organization that holds **all** the membership rights or interest in another not-for-profit organization. Under the Guide, sole corporate membership in a not-for-profit organization is equivalent to a controlling financial interest because a sole corporate member is the only interest holder in the not-for-profit organization.

Unlike the Guide, SOP 94-3 is silent on whether sole corporate membership represents a controlling financial interest. Because the concept of a sole corporate member is equally applicable to not-for-profit organizations that follow SOP 94-3, the FSP amends SOP 94-3 to include the concept of a sole corporate member in the definition of a controlling financial interest.

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Definition of Majority Voting Interest

Because not-for-profit organizations exist in various legal forms, control of a not-for-profit organization may not always be established by a majority ownership interest. SOP 94-3 and the Guide acknowledge that control may also exist through means such as a contract or an affiliation agreement. In such cases, SOP 94-3 and the Guide require consolidation (even in the absence of a majority ownership interest or sole corporate membership) when a not-for-profit organization has control through a majority voting interest in the board of another entity if that control is also coupled with an economic interest in the entity.

Questions have emerged about the definition in SOP 94-3 of "a majority voting interest in the board of another entity" and the example (which is also in the Guide) that states:

> Entity B has a five-member board, and a simple voting majority is required to approve board actions. Entity A will have a majority voting interest in the board of entity B if three or more entity A board members, officers, or employees serve on or may be appointed at entity A's discretion to the board of entity B. However, if three of entity A's board members serve on the board of entity B but entity A does not have the ability to require that those members serve on the entity B board, entity A does not have a majority voting interest in the board of entity B.

This example has prompted several not-for-profit organizations to question whether a majority voting interest in the board of another entity can exist if the not-for-profit organization has the ability to appoint individuals other than its own board members, officers, or employees. Because the example indicates that entity A has a majority voting interest if it can appoint "three or more [of its] board members, officers, or employees," many practitioners have expressed uncertainty about whether the appointment of an individual not affiliated with the organization results in control. In addition, several not-for-profit organizations have questioned whether a majority voting interest in the board of another entity can temporarily exist if, because of board seat vacancies, the not-for-profit has the current ability to appoint a majority of the *currently filled* board positions.

[7] The Guide applies to both for-profit and not-for-profit governmental and nongovernmental health care organizations. The amendments in the FSP are specific to nongovernmental not-for-profit health care organizations. Accordingly, and for consistency with the terminology in SOP 94-3, the remainder of this *Heads Up* refers to not-for-profit nongovernmental health care organizations as not-for-profit organizations.

In response to these implementation questions, the FSP clarifies that a not-for-profit organization does not have to appoint its own board members, officers, or employees to have a majority voting interest in the board of another entity. Rather, control through a majority voting interest in the board of another entity can exist regardless of the individual appointed to the board. In addition, the FSP clarifies that a not-for-profit organization is deemed to have control through a majority voting interest in the board of another entity only if it has the ability to **appoint** a majority of the full board *including* vacant board positions. The ability to appoint a majority of the currently filled board positions but not a majority of the full board does not result in control.

Elimination of the Temporary Control Exception

In 2001, Statement 144[8] amended ARB 51 to eliminate the exception to consolidation when control of a subsidiary was expected to be temporary. At that time, conforming changes were also made to SOP 94-3 and the Guide when consolidation was required as a result of a controlling financial interest. However, the application of the temporary control exception continued to be applicable when consolidation was required on the basis of control through means other than a controlling financial interest (e.g., control through a contract or an affiliation agreement).

This FSP eliminates the exception to consolidation in SOP 94-3 and the Guide if a not-for-profit organization temporarily controls another entity through means other than a controlling financial interest.

To increase the consistency in financial reporting between for-profit entities and not-for-profit organizations, this FSP eliminates the exception to consolidation in SOP 94-3 and the Guide if a not-for-profit organization temporarily controls another entity through means other than a controlling financial interest.

Applicability of Issues 90-15, 96-21, and 97-1 to SPE Lessors

In 2003, the FASB issued Interpretation 46(R),[9] which nullified much of the consolidation guidance specific to involvements with SPEs, including Issues 90-15, 96-21, and 97-1. However, paragraph 4(e) of Interpretation 46(R) specifically excludes from its scope not-for-profit organizations. Because of this, some have questioned whether the consensus guidance in Issues 90-15, 96-21, and 97-1 continues to apply. The FSP clarifies that the guidance in Issues 90-15, 96-21, and 97-1 is in fact applicable to not-for-profit organizations that are not within the scope of Interpretation 46(R). Accordingly, not-for-profit organizations that have involvements with an SPE lessor must consider the guidance in Issues 90-15, 96-21, and 97-1 to determine whether consolidation of the SPE lessor is required.

In addition to confirming the applicability of Issues 90-15, 96-21, and 97-1, the FSP clarifies that for purposes of analyzing a not-for-profit organization's involvement with an SPE lesssor, consolidation is required pursuant to Issue 90-15 if the majority owner of the SPE lessor is not independent of the not-for-profit organization (regardless of the level of capital investment). The FSP, however, does not provide guidance on whether Issues 90-15, 96-21, and 97-1 should be analogized to interests in entities other than SPE lessors. SEC guidance included in Issue 90-15 broadened the scope of Issue 90-15 to transactions with SPEs other than those addressed by Issue 90-15. However, because many not-for-profit organizations are not subject to SEC reporting requirements, it is unclear whether the guidance in Issues 90-15, 96-21, and 97-1 is broadly applicable to involvements with **any** SPE.

[8] FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets.*
[9] FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities.*

Editor's Note: In redeliberations of the proposed FSP, the Board spent a significant amount of time discussing whether to require not-for-profit organizations to consider the SEC guidance included in Issue 90-15 and Topic No. D-14[10] when analyzing transactions involving SPEs. Because of the narrow scope of this project, the Board chose not to explicitly address this issue in the FSP. The FSP is therefore silent on whether Issue 90-15 and Topic No. D-14 are applicable to not-for-profit organizations that have interests in SPEs other than leasing entities. Consultation with accounting advisors is recommended when considering the applicability of the guidance in these Issues.

Requirement to Apply Equity Method Accounting

SOP 94-3 and the Guide explicitly provide that the guidance on the equity method included in Opinion 18[11] is applicable to not-for-profit organizations with investments in the common stock (or in-substance common stock) of for-profit entities. However, SOP 94-3 and the Guide were less clear on the applicability of the equity method to investments in for-profit entities that are not in corporate form (e.g., partnerships, LLCs, and similar entities). This lack of clarity was compounded by the guidance in the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*, which allowed a not-profit organization to carry certain "other investments" at cost rather than fair value.

The FSP removes this uncertainty by requiring that not-for-profit organizations apply the guidance on use of the equity method in Opinion 18 to their investments in for-profit real estate partnerships, LLCs, or similar entities that are considered more than a minor noncontrolling interest. The FSP also clarifies that not-for-profit organizations should consider the guidance in both FSP SOP 78-9-1[12] and Issue 03-16[13] to determine whether the equity method is applicable to its investments.

Editor's Note: If the equity method is applied to certain investments in for-profit partnerships, LLCs, or similar entities, Opinion 18 requires detailed disclosures of these investments. Such disclosures would include (1) the difference between (a) the carrying value of the equity method investment and (b) the net assets of the investee, and the accounting treatment of that difference and (2) summarized information on the assets, liabilities, and results of operations of the investee (if the investment is material to the reporting entity).

[10] EITF Topic No. D-14, "Transactions Involving Special-Purpose Entities."
[11] APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*.
[12] FASB Staff Position No. SOP 78-9-1, "Interactions of AICPA Statement of Position 78-9 and EITF Issue No. 04-5."
[13] EITF Issue No. 03-16, "Accounting for Investments in Limited Liability Companies."

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