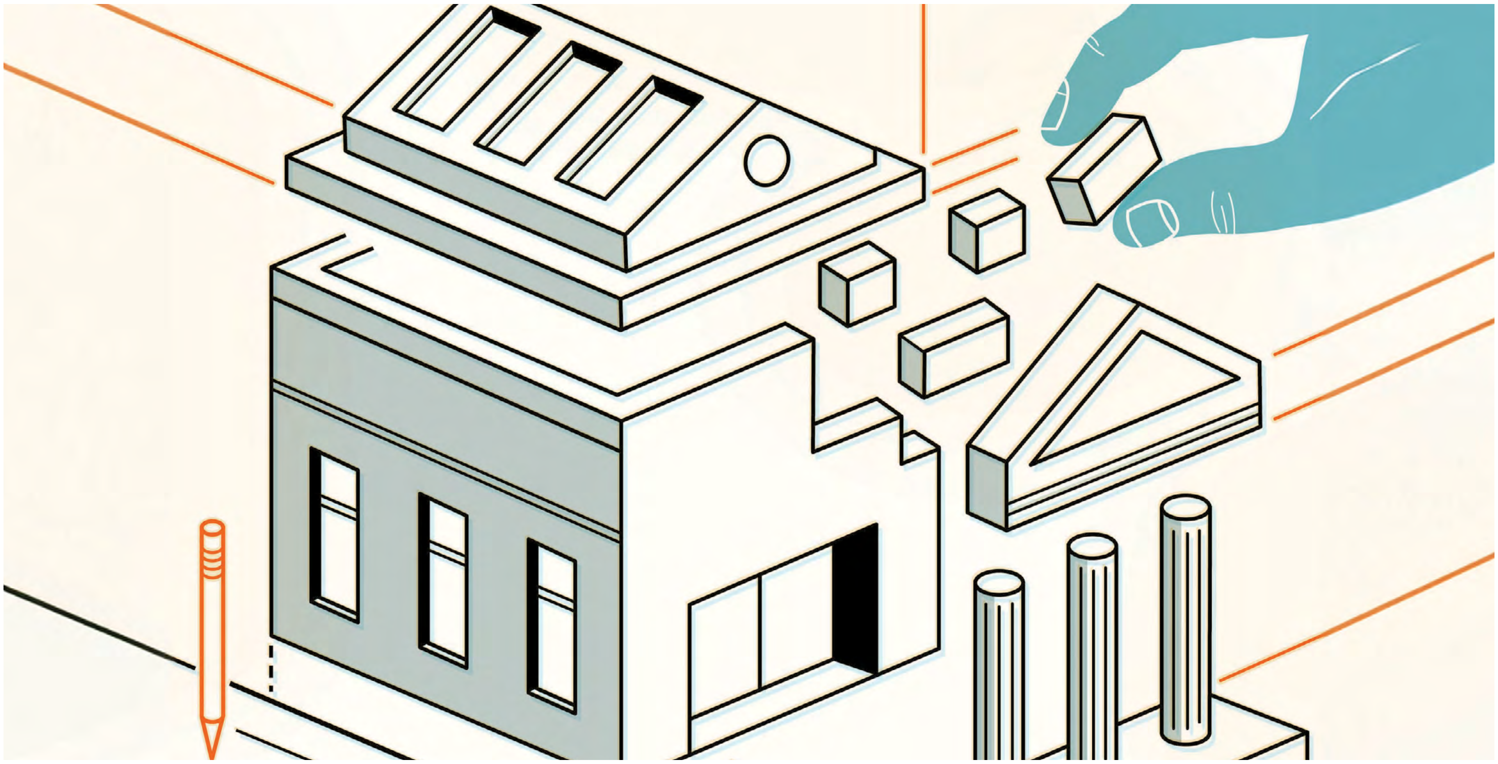

ACCOUNTING

Inside Stories #3

Financial Reporting for Activity with Blended Component Units

BY MICHELE MARK LEVINE

Generally accepted accounting principles (GAAP) for governments, which are set by the Governmental Accounting Standards Board (GASB), use a financial reporting model based on the financial accountability of elected officials. In government, a set of basic financial statements can include any number of legally separate governmental entities in cases where elected officials of one government are financially accountable for the affairs of other governments or where the exclusion of a separate entity would make the financial statements of the financial reporting entity misleading.[1] The government with financial accountability for others is called the primary government, and the other included entities are called component units.[2]

This is the third in a series of articles exploring some of the complexities that arise from this special form of consolidation termed a *financial reporting entity*. The earlier articles focused on distinguishing between cash flows and resource flows within the financial reporting entity,[3] and on reporting requirements for defined benefit postemployment benefits (pension and other postemployment benefits) when multiple employer governments within a financial reporting entity provide benefits in a plan that recognizes them jointly as a single employer.[4] Here, we'll focus specifically on activity between the primary government and a subset of its component units, those that meet criteria demonstrating that they are so much a part of the primary government's own activities that they should be reported just as if they were part of the primary government's legal entity, which are called blended component units.[5]

Blended component units (BCUs) are reported as one or more funds of the primary government in the financial reporting entity financial statements. Activity between a primary government (PG) and that PG's BCUs, or between multiple BCUs of the same PG, need to be reported as interfund activities

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in the financial reporting entity's financial statements. Specifically, in fund activity statements (such as, statements of revenues, expenditures, and changes in fund balance for governmental BCUs reported in governmental funds, or statements of revenues, expenses, and changes in fund net position for business-type activity BCUs reported as enterprise funds), such internal activities are reported either as interfund services provided and used or as interfund transfers, depending on whether or not the activity is reciprocal. On position statements (as in, balance sheets for governmental funds or statements of fund net position for enterprise funds), amounts due need to be reported as fund assets and liabilities ("due from..." and "due to..."). The interfund balances are eliminated as part of the consolidation process for government-wide financial statements of the financial reporting entity.[6]

A BCU, although legally separate, may be operated as if it were part of the primary government, with its activities accounted for directly in one or more funds of the primary government in which no other activities are accounted for. If so, only routine conversion and combining entries, including eliminations of interfund balances and transfers, will need to be made as part of the annual closing and financial statement preparation. However, a BCU sometimes maintains its own accounting system and issues stand-alone financial statements, and either the BCU or the PG, or both, may treat internal activities throughout the year as if they occurred with external parties. If so, the financial reporting entity's financial statement preparation may require a bit more work. Let's address a few specific examples where there is activity between a PG and one or more of its BCUs, or between multiple BCUs of the same PG, which require additional attention when preparing financial reporting entity financial statements:

1. General funds of BCUs and classification of fund balances and net position.
2. "Leases" (quotation marks to be explained momentarily).
3. Loans of externally borrowed resources.
4. Purchases and sales of future revenues.
5. Financial guarantees.
6. Additional note disclosure considerations.

1. General funds of BCUs and classification of fund balance and net position

No set of basic financial statements can include more than a single general fund, so if a governmental BCU has a general fund, it will need to be reported as a special revenue fund in financial reporting entity governmental funds financial statements. This is the only instance where a special revenue fund need not have a specific restricted or committed revenue source that is expected to provide a significant portion of that fund's inflows.

Moreover, because only a general fund should report a positive unassigned fund balance, and because the BCU's fund balance is intended to be used only for the BCU's purposes, any unassigned fund balance reported in the BCU's general fund in its stand-alone financial statements will need to be reclassified into restricted, committed, or assigned fund balances when included in the financial reporting entity's governmental funds financial statements. The reclassification should be based on what the PG would need to do to use the BCU's resources for *unrelated purposes*. If the PG could only repurpose the BCU's resources with permission (such as, by obtaining changes in laws, regulations, or contract terms) from an external party or parties, which would otherwise be able to enforce a limitation to use them for the BCU's purposes, those resources would be reported as part of restricted fund balance of the special revenue fund. If action of the primary government alone is sufficient to repurpose resources, they would be reported as part of the fund's committed fund balance or assigned fund balance, based on the level and type of action by the PG that would be required.[7] See item 3, intra-entity lending of externally borrowed resources, for an example of how the blending of component units can also affect the classification of net position.

2. Intra-entity "leases" with or among BCUs

GASB's definition of a lease as "a contract that conveys control of the right to use another entity's nonfinancial asset (the underlying asset) as specified in the contract for a period of time in an exchange or exchange-like transaction"[8] specifically excludes arrangements within a single entity, as the underlying asset must be that of "another entity." Because a BCU is a legally separate entity from its PG, a BCU's stand-alone financial statements would report an arrangement with its PG or with another BCU of its PG as a lease if it meets the other criteria to be a lease. However, in the financial reporting entity financial statements where the BCU is reported as part of the primary government, the fund financial statements will need to report the activity as an interfund service provided and used, without the separate recognition of principal and interest, rather than in accordance with GASB Codification Section L20, Leases (GASB 87, as amended).

Note that over time, when reported on an economic resources measurement focus and an accrual basis of accounting (for example, when reported anywhere other than in a governmental fund), a lease may affect

With the implementation of GASB Statement No. 100, *Accounting Changes and Error Corrections*, both financial statement displays and disclosures will be needed whenever a component unit is added or removed as well as when the treatment of a component unit changes from being blended to being discretely presented or vice versa.

the parties' net positions, as lease assets and lease liabilities (of governmental lessees) may be amortized at different rates. Also, the amounts of lease and interest income (of a governmental lessor) or amortization and interest expenses (of a governmental lessee) could conceivably be unequal if they were calculated using different discount rates or if they used different assumptions about the lease term. Any net effects on fund net position or government-wide net position will need to be eliminated. This means that the BCU's stand-alone financial statements may report a different net position amount than that reported for the same BCU in the financial reporting entity fund or government-wide financial statements. An illustration of the accounting and reporting for an intra-entity "lease" can be found in as part of GFOA's Journal Entry Examples: Leases.[9]

3. Intra-entity lending of externally borrowed resources

In almost all cases, loans within a financial reporting entity are not considered to be capital liabilities of the borrowing reporting unit, regardless of whether or not the proceeds were used to acquire, construct, develop, or improve the borrower's capital assets, and of course they are eliminated from the primary government total columns in the financial reporting entity's government-wide financial statements. The exception to this rule is that if a BCU borrows money *externally*, such as by issuing bonds, and then loans the proceeds of that external borrowing to its PG or to another BCU of its PG (the internal borrower); then the internal borrower would treat its liability to the BCU that originally borrowed the funds externally (the internal lender) as a capital liability to the extent the proceeds have been spent by the internal borrower to acquire, construct, develop, or improve its capital assets (collectively referred to henceforth as "acquire"). The outstanding obligation to the internal lender would reduce the internal borrower's net investment in capital assets, as the proceeds of its internal borrowing were used to acquire capital assets. The internal lender, not having used proceeds of its external borrowing for its capital assets (it holds only a receivable) would report its liability to the external creditors as part of its unrestricted net position.[10] However, if the internal borrower and the internal lender are blended into the same primary government total in the financial reporting entity government-wide financial statements, the capital assets and the liability to the external party or parties would then be in the same reporting unit and the liability would be included in the calculation of net investment in capital assets.

4. Intra-entity purchases and sales of future revenues

Sometimes a government (the seller) creates a legally separate entity and then sells a stream of the seller's future revenue to the new entity (the buyer) to use as security for a bond issue or a loan from an external third party, in exchange for the proceeds of that bond or loan. These buyer entities will usually meet the criteria to be reported as BCUs of the creating government.[11] As a result, the deferred inflows of resource reported by the seller, and deferred outflows of resources reported by the buyer, plus the value of any residual interest in the sold revenues retained by the seller, will need to be reported in the appropriate funds in the financial reporting entity's governmental or enterprise funds financial statements, and will need to be eliminated in the financial reporting entity's government-wide financial statements.[12]

5. Financial guarantees

A government that guarantees (the guarantor) another party's (the indebted party) liability will report a liability for the amount, if any, of debt service it is more likely than not to pay on behalf of the indebted party. If (1) a PG guarantees a liability of its BCU, (2) a BCU guarantees a liability of its PG, or (3) one BCU of a PG guarantees a liability of another BCU of its PG, and if the guarantor recognizes a liability for debt service payments on behalf of the indebted, the guarantor will also recognize an equal amount as being receivable from the indebted entity. If the guarantor is a BCU, it will report the receivable in both its stand-alone financial statements and when blended into the financial reporting entity's fund financial statements. That interfund receivable will be eliminated in the financial reporting entity's government-wide financial statements. Otherwise, the total reported liability will be overstated.[13]

Additional note disclosure considerations for PGs with BCUs

Generally, note disclosures focus on the primary government, including the governmental activities, business-type activities, major funds, and non-major funds in the aggregate.[14] In this context, *primary government* includes both the PG and its BCUs.[15] The summary of significant accounting principles (SSAP) should detail all the component units included in a set of financial statements, including the specific facts and circumstances that meet the criteria for inclusion of each component unit. For each BCU, the SSAP should also disclose the specific facts and circumstances that meet the criteria requiring blending, as the default treatment of a component unit is discrete presentation. All detailed note disclosures required for basic financial statements need to include information about the BCUs in the financial reporting entity. Notes on deposits, investments, capital assets, outstanding debt, postemployment benefits, and contingencies, for example, will all need to include those of all BCUs.

Funds of the PG or funds representing BCUs in the financial reporting entity financial statements that are reported as major funds may have significant activity with funds representing BCUs that are not reported as major funds. If disclosures related to the major fund's activity would be incomplete without the inclusion of information about a non-major BCU fund, such as if a gain or loss in a major fund is significantly offset by a gain or loss in a non-major fund BCU, the disclosure should be expanded to include the related information about the BCU.[16]

Other disclosure requirements with specific implications when there are BCUs in a financial reporting entity's financial statements include the general requirement to disclose interfund eliminations not apparent on the face of financial statements and to disclose inconsistencies in financial statements caused when component units have different fiscal year ends.[17]

Finally, with the implementation of GASB Statement No. 100, *Accounting Changes and Error Corrections*, both financial statement displays and disclosures will be needed whenever a component unit is added or removed as well as when the treatment of a component unit changes from being blended to being discretely presented or vice versa.

The blending of appropriate component units into the financial statements of a primary government is a great example of the principle that accounting and financial reporting should communicate the economic substance of relationships, transactions, and other events, rather than their legal form. However, a governmental entity is legally constituted, if in substance it is simply a part of another entity, and GAAP-based financial statements should reflect that substance.

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[1] For authoritative guidance on identifying and accounting for governmental financial reporting entities, primary governments, and component units, see the GASB Codification of Governmental Accounting and Financial Reporting Standards (Cod.) Section (Sec.) 2100, "Defining the Financial Reporting Entity" and Cod. Sec. 2600, "Reporting Entity and Component Unit Presentation and Disclosure".

[2] In the remainder of this article, the abbreviation "PG" is used when referring exclusively to the single legal entity serving as the core of a financial reporting entity, excluding its blended component units (BCUs). When "primary government" is used to refer to both the PG and its BCUs, as it is generally used in GAAP, the words are spelled out. The phrase "financial reporting entity financial statements" is used to refer to the basic financial statements of the primary government and all its component units.

[3] Michele Mark Levine, "Inside Stories #1: Distinguishing Between Internal Cash Flows and Internal Resource Flows," *GFR*, October 2023.

[4] Michele Mark Levine, Todd Buikema, and Susannah Filipovic, "Inside Stories #2: Accounting and Financial Reporting When Multiple Governments Within One Financial Reporting Entity Are a Single Employer for a PEB Plan," *GFR*, December 2023.

[5] For a refresher on when and how multiple legally separate governments should be included in a single financial reporting entity, please review: Michele Mark Levine, "Puzzling Pieces: Component Unit Identification, Classification, Disclosure, and Display," *GFR*, April 2022.

[6] GASB Cod. Sec. 2200, "Annual Comprehensive Financial Report," paragraphs .151 and .725-1.

[7] GASB Cod. Sec. 1800, "Classification and Terminology," paragraph .747-6.

[8] GASB Codification Section L20, Leases, paragraph .102.

[9] GFOA's Journal Entry Examples: Leases, in Example 6, Scenario C, gfoa.org/materials/journal-entry-examples-leases.

[10] GASB Cod. Sec. 1800, Classification and Terminology, paragraph .734-11.

[11] GASB Cod. Sec. 2100.601.

[12] A good illustration of this can be found in GASB's Codification of Governmental Accounting and Financial Reporting Standards (Cod.), in illustration 2 to Cod. Section S20, "Sales and Pledges of Receivables and Future Revenue." This can be found in GASB's Governmental Accounting Research System at gars.gasb.org, by following this pathway: *Codification* → *IV. Specific Balance Sheet and Operating Statement Items* → *S20—Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues* → *Nonauthoritative Discussion* and scrolling to the second illustration.

[13] Cod. Sec. F30, Financial Guarantees, paragraph .110.

[14] Cod. Sec. 2300, Notes to financial statements, paragraph .102.

[15] See note 3.

[16] Cod Sec D20.116.

[17] Cod. Sec. 2300.107 l. and p.