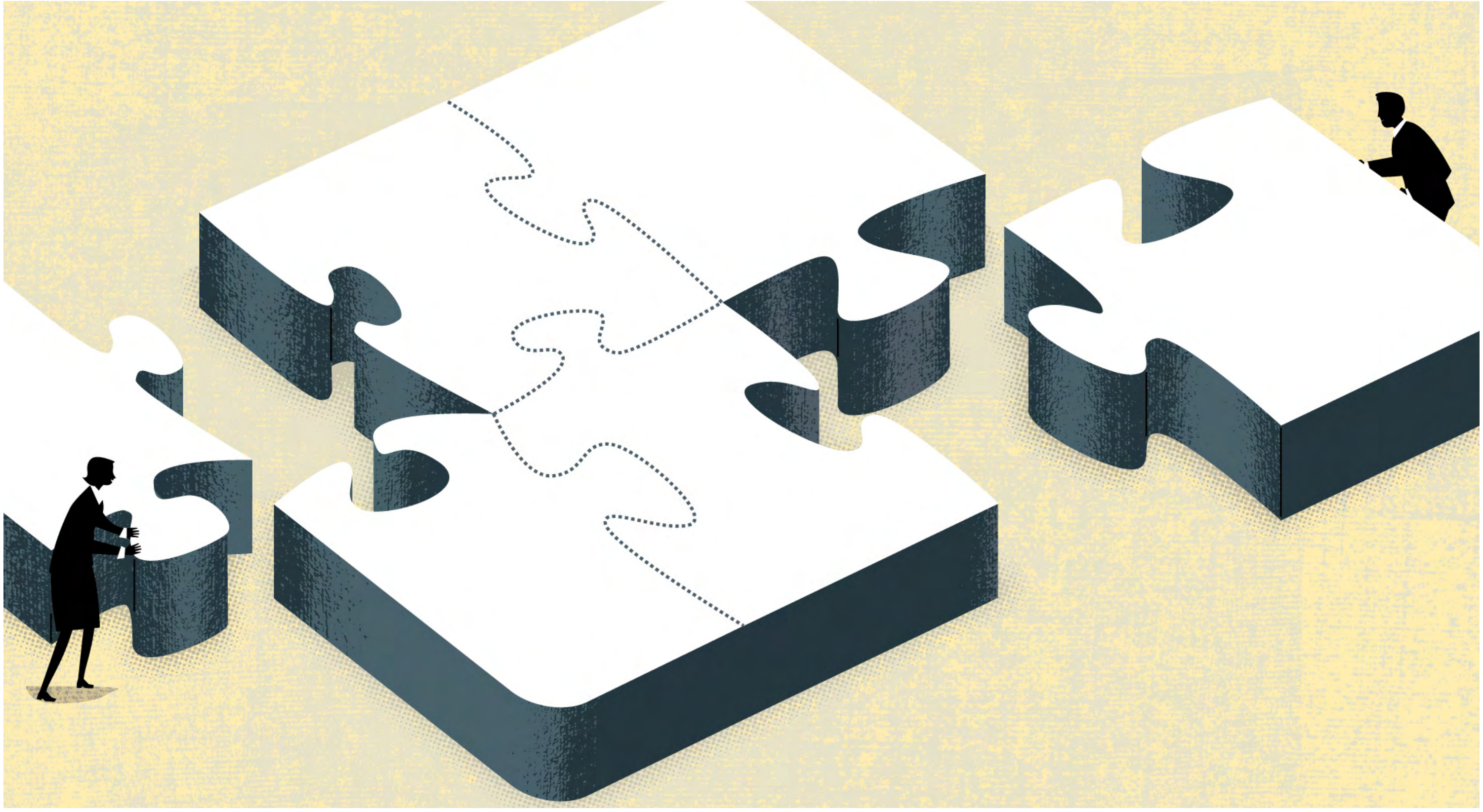


ACCOUNTING

Puzzling Pieces

Component Unit Identification, Classification, Disclosure, and Display

BY MICHELE MARK LEVINE

Although the basic shape of the financial reporting entity for state and local governments has been around for nearly 30 years, the Governmental Accounting Standards Board (GASB) has made many incremental changes over time. Most recently, GASB Statements No. 84, *Fiduciary Activities*, No. 90, *Majority Equity Interests*,[1] and No. 97, *Certain Component Unit Criteria, and Accounting and Financial Reporting for Internal Revenue Code Section 457 Deferred Compensation Plans*[2] have introduced such changes. So, it is not terribly surprising that governments sometimes struggle to determine which entities should be included in a set of basic financial statements prepared in accordance with generally accepted accounting principles (GAAP), how they should be reported, and how both determinations should be explained.

Financial accountability

Basic financial statements are built around an organizing principle of the *financial accountability* of elected officials. The elected officials of one government are often financially accountable for both the government they were elected to lead and for one or more legally separate entities, so several legal entities together must be the subject of a set of basic financial statements. The "main" government, often a general purpose government such as a state, county, or municipality, is referred to as the *primary government*,[3] and those legally separate entities for which the primary government's elected officials are financially accountable, or for which exclusion would cause the primary government's financial statements to be misleading,[4] are called *component units*.[5] Together, a primary government and its component units, if any, compose a single *financial reporting entity*.[6]

In most cases, a component unit meets two criteria, one which can be thought of as a primary factor and the other as a secondary factor. The primary factors are either that (1) the primary government (mayor, governor, legislature) appoints a voting majority of the separate entity's governing board, referred to as *board appointment*; or (2) the primary government has substantive authority to make or approve key financial decisions for the separate entity, referred to as *fiscal dependence*.

Board appointment authority must be both:

- **Substantive.** The choice of appointees cannot be significantly limited, such as to those nominated by another government, organization, or outside individual. If the government's role is to confirm appointments made by another, the confirmation must be more than just a formality.[7]
- **Ongoing.** The choice of future appointees must remain that of the primary government, rather than, for example, the primary government just choosing the initial membership of a self-perpetuating board. Alternatively, the primary government may have the authority "to unilaterally abolish" the separate entity, giving the primary government ongoing authority over the entity even if the future board members are selected by another means.

Even appointing a majority of a governing board's members, however, might not be sufficient to make one government financially accountable for a separate legal entity—such as in the case where the primary government appoints 60 percent of the board members—but all financial decisions must be made by a 75 percent supermajority. Thus, the primary factor of board appointment must be accompanied by one of two secondary factors.

The secondary factors are either that (a) the primary government is able "to significantly influence the programs, projects, activities, or level of services performed or provided by" the separate entity, referred to as *imposition of will*,[8] or (b) the separate entity has the potential to provide specific financial benefits to, or impose specific financial burdens on, the primary government, referred to as a *financial benefit or burden relationship*. Generally, if the primary government has the ability to, at will, appoint and remove members of the separate entity's governing board or its management; to approve or modify the separate entity's budget, rates, or fees; or to overrule other decisions of the governing board, it has the ability to impose its will on that separate entity. A financial benefit or burden relationship exists when the primary government (1) can access the separate entity's resources, (2) is obligated to finance the deficits of the separate entity, (3) is somehow responsible for its debt, or (4) is obligated to make contributions to a defined benefit postemployment benefit plan, if one exists.[9]

Fiscal dependence, the second of the two primary factors, exists when the separate entity requires the primary government's substantive authority to, for example, approve the separate entity's budget, fees, or debt issuances, or if the primary

Basic financial statements are built around an organizing principle of the financial accountability of elected officials.

EXHIBIT 1 | CRITERIA FOR FINANCIAL ACCOUNTABILITY/COMPONENT UNIT

Board appointment	+	Ability to impose will	=	Financial accountability
Board appointment	+	Financial benefit or burden	=	Financial accountability
Fiscal dependence	+	Financial benefit or burden	=	Financial accountability
Majority equity interest that is not an Investment			=	Financial accountability

government must levy taxes on behalf of the separate entity. Fiscal dependence must be accompanied by the secondary factor of a financial benefit or burden relationship to make the primary government financially accountable for the separate entity.

Finally, when one government owns a majority equity interest in a separate entity—other than an interest that is held as an investment[10] —that majority equity interest alone makes the owner government financially accountable for the separate entity.[11] See Exhibit 1 for a summary of the criteria for determining financial accountability of a primary government for a separate legal entity, making that entity its component unit.

In addition to using these criteria to determine whether a separate entity is a component unit, a primary government must use its disclosures to explain specifically which criteria have been met for each component unit it includes in its reporting entity. Simply stating that the primary government is financially accountable for an entity is insufficient; the disclosure must explain why. Here are some examples of properly worded disclosures:

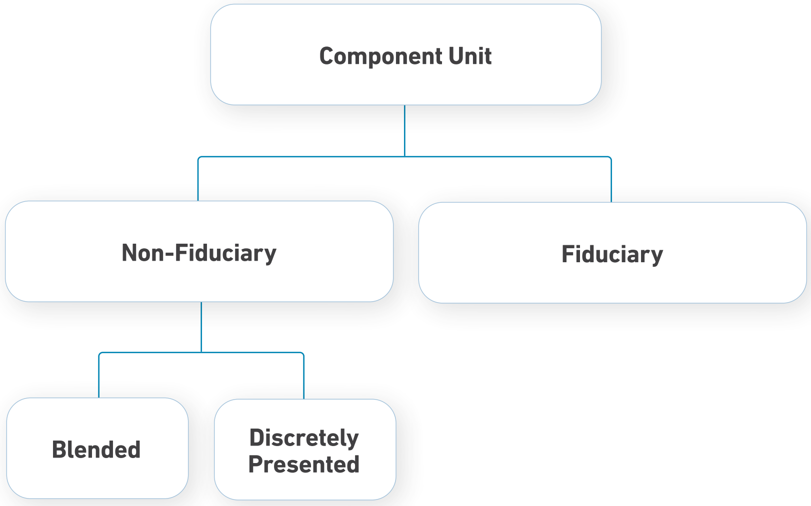
- The Sample City Economic Development Corporation (EDC) is a public benefit corporation and is a component unit of Sample City because the city council also serves as EDC's board of directors. (Board appointment and ability to impose will)
- The Sample City Recreation Financing Corporation (RFC) is a component unit of Sample City because all members of RFC's board of directors serve ex-officio by virtue of their city positions, in which all serve at the pleasure of the city mayor. (Board appointment and ability to impose will)
- The Sample City Police and Fire Employee Retirement System (PAFERS) is a defined benefit pension plan that has a board composed equally of representatives of the city management and representatives elected by the members of the bargaining units representing police and fire employees. PAFERS is a component unit of the city because the city must approve PAFERS' annual budget, and because the city is required by contractual obligations to make contributions to PAFERS. (Fiscal dependence and financial benefit or burden)
- The Sample Power Authority (SPA) is a public authority and component unit of the city because the city mayor appoints a voting majority of SPA's governing board and the city guarantees payment of SPA's outstanding bonds, in the event that SPA is unable to do so. (Board appointment and a financial benefit or burden)
- The Sample City Museum Corporation is a nonprofit corporation and a component unit of the city because the city council must annually approve the museum's budget, and the city has publicly stated its intent to provide ongoing financial support for the museum. (Fiscal dependence and a financial benefit or burden)
- The Sample City Employees Health Services Corporation (EHS) is a nonprofit corporation whose members are the city's employees and a board of directors composed equally of representatives of city management and representatives elected by the members of the bargaining units representing all city employees. EHS is a component unit of the city because the city council must approve the EHS annual budget, and the city is obligated to provide funding to cover any deficits arising from its operations. (Fiscal dependence and financial benefit or burden)[12]

A primary government must use its disclosures to explain specifically which criteria have been met for each component unit it includes in its reporting entity.

Methods of incorporating component units

Of course, the nature of the relationship between a primary government and a component unit can vary greatly, from situations in which the governance and operation of the component unit is essentially indistinguishable from that of the primary government, to those where the governing board is independently elected (school board) or appointed entirely by a higher level of government (state industrial development authority), but the primary government (county), for example, approves the separate entity's bond issuances and guarantees its debt. Because of the varying nature of the relationships, some component units are displayed in financial statements as if they are simply funds of the primary government, which we call blended component units, and others are clearly distinguished from the primary government on the face of the financial statements as well as in note disclosures, which we call *discretely presented component units*.

EXHIBIT 1 | FIDUCIARY COMPONENT UNITS



The final category of component units is fiduciary component units such as pension plans, other postemployment benefit plans (retiree health plans), and other employee benefit plans (tax-deferred savings plans to which the employer does not contribute) are always reported as part of—essentially blended into—the primary government's fiduciary fund financial statements. Once a separate entity is identified, it should be evaluated first to determine if it is a fiduciary component unit, and if not, to determine if it meets the criteria to be blended. All others should be discretely presented. (See Exhibit 2)

For non-fiduciary component units,[13] the presumption is that they should generally be discretely presented because they are legally separate entities.[14] But accounting and financial reporting focus on economic substance rather than legal form. So that presumption is overcome, and a component unit is blended when the facts and circumstances demonstrate that the legally separate entity is, in substance, part of the primary government. A component unit should be blended:

- If it has a governing board that "is substantively the same as the governing body of the primary government" *(same governing body)*, and either
  - Managers of the primary government also manage the component unit, similarly to the way in which the primary government's own affairs are operated *(same management)*, or
  - There is a financial benefit or burden relationship, as discussed above;
- If it exclusively (or almost exclusively) provides services to the primary government or benefits the primary government, rather than to the public, including if it benefits the primary government by providing services to its employees on the government's behalf (*exclusive benefit*);[15]
- If all its outstanding debt, including lease debt, will be paid entirely or nearly entirely with resources of the primary government (*all debt funded*); or
- If a component unit is a nonprofit corporation and the primary government is the only corporate member of (*sole corporate member*).

See Exhibit 3 for a summary of the criteria for determining if a component unit should be blended.[16]

Just as with the requirement to disclose the specific reasons why a separate entity is a component unit of a primary government, the primary government is required to disclose the specific reasons why a component unit is blended, rather than discretely presented. Building on the example disclosures above, following are examples of language that may be used to explain why certain component units would be blended. Remember that both explanations as to why a separate entity is a component unit and, when applicable, why a component unit is blended rather than discretely presented, are required for each component unit.

- Because the EDC governing board and the city council membership is the same, and the city's management also manages the operations of EDC, EDC's activities are reported as an enterprise fund in the city's proprietary fund financial statements and in business-type activities in the city's government-wide financial statements, as if it were a part of the city. (Same governing body and same management)
- RFC's outstanding bonds are supported solely by the city's sports arena and public theater revenues, which have been pledged by the city to RFC in exchange for the RFC's bond proceeds, which have been used to construct and improve these venues. Therefore,

EXHIBIT 3 | CRITERIA FOR BLENDING COMPONENT UNITS

Same governing body	+	Same management	=	Blended component unit
Same governing body	+	Financial benefit or burden	=	Blended component unit
Exclusive benefit to the primary government			=	Blended component unit
All debt of the component unit will be paid using resources of the primary government			=	Blended component unit
The primary government is the sole corporate member of a nonprofit component unit			=	Blended component unit

RFC is reported as a debt service fund in the city's governmental fund financial statements and in governmental activities in the city's government-wide financial statements, as if it were part of the city. (All debt funded)

- As a fiduciary component unit of the city, PAFERS is included as a pension (and other employee benefit) trust fund in the city's fiduciary fund financial statements and is excluded from the city's government-wide financial statements. (N/A—fiduciary component unit)
- SPA provides electrical power directly to the city's residents and businesses, as well as to the city government itself, and is reported as a discretely presented component unit on the city's government-wide financial statements. (N/A—discretely presented)
- Because the city is the sole corporate member of the museum, the museum's activities are reported as an enterprise fund in the city's proprietary fund financial statements and in business-type activities in the city's government-wide financial statements, as if it were a part of the city. (Sole corporate member)
- Because EHS provides medical services exclusively to city employees in lieu of the city providing third-party medical insurance covering those services, EHS activities are reported as a special revenue fund in the city's governmental fund financial statements and in governmental activities in the city's government-wide financial statements, as if it were part of the city.[17] (Exclusive benefit)

Display of component units

Once we have determined which component units will be blended and which discretely presented, more work is needed to correctly display them in GAAP financial statements. Funds that report balances and activities of blended component units (component unit funds) must be classified as being *major* or *nonmajor* funds, like all other governmental and enterprise funds. A component unit fund that meets the GAAP criteria to be reported as a major fund,[18] or one that is deemed by the government to be properly reported

Both explanations as to why a separate entity is a component unit and, when applicable, why a component unit is blended rather than discretely presented, are required for each component unit.

as a major fund based on professional judgment, is displayed as a separate column in either the governmental fund financial statements or the proprietary fund financial statements, as appropriate.[19] If a blended component unit has its own general fund, that fund will be reported as a special revenue fund in the governmental fund financial statements, and it will be subject to the same analysis as other special revenue funds for the purpose of major fund determination.

Other component unit funds are nonmajor funds, which are aggregated with any other nonmajor governmental funds or enterprise funds, as appropriate, in a single column in the governmental funds or proprietary funds financial statements, respectively. Combined fund financial statements showing individual nonmajor funds, including nonmajor component unit funds, should be included in supplementary information in the financial section of an annual comprehensive financial report (ACFR).

Each discretely presented component unit also needs to be classified as major or nonmajor. Unlike with governmental and enterprise funds, however, no quantitative thresholds definitively identify major discretely presented component units. Instead, the determination requires professional judgment "based on the nature and significance of (the component unit's) relationship to the primary government."[20] Factors that would indicate a significant relationship include when a component unit provides services directly to the public, such that separate reporting is considered essential to users; when there are significant transactions between the component unit and primary government; or when there is a significant benefit or burden relationship. Major component units must be individually reported within the reporting entity's basic financial statements in one of three ways: 1) on the face of the government-wide financial statements; 2) in combining statements following the fund financial statements; or 3) in condensed financial statements in note disclosures.

Nonmajor discretely presented component units may be presented either individually or in aggregate on government-wide or combining statements in the basic financial statements. If aggregated on the face of financial statements, combining financial statements showing individual nonmajor discrete component units should also be included in supplementary information in the financial section of an ACFR.

The financial reporting entities for which state and local governments prepare GAAP financial statements require the careful arrangement of many separate pieces, and our disclosures explain why those puzzle pieces chosen are the right ones and why their arrangement is the correct one to reveal a clear picture of accountability for public funds.

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1 The full name of GASB Statements No. 90 is *Majority Equity Interests—an amendment of GASB Statements No. 14 and No. 61.*

2 The full name of GASB Statement No. 97 is *Certain Component Unit Criteria, and Accounting and Financial Reporting for Internal Revenue Code Section 457 Deferred Compensation Plans—an amendment of GASB Statements No. 14 and No. 84, and a supersession of GASB Statement No. 32.*

3 A primary government is any state or general purpose local government or a special purpose government that is a separate legal entity that has a separate, popularly elected, governing body and that is fiscally independent from other state or local governments (GASB Cod. Sec. 2100.112-.113).

4 Occasionally a primary government may include, as a component unit, a separate legal entity for which it is not financially accountable based on the criteria discussed herein. This is done when, using professional judgement, a primary government's management determines that the exclusion of the separate entity from its financial statements would make those statements misleading. GASB provides limited additional guidance on this determination as it relates to (1) financing authorities that issue debt on behalf of local governments and (2) to not-for-profit organizations. See GASB Cod. Sec. 2100.140.

5 GASB *2021-2022 Codification of Governmental Accounting and Financial Reporting Standards* (Cod.), Section (Sec.) 2100, "Defining the Financial Reporting Entity," paragraph .109.

6 A government that is a component unit of a primary government may issue a set of financial statements that includes only that individual entity's—and that of its own component units, if any—financial position and results of operations, which we call stand-alone financial statements. In such statements, that component unit is reported just like a primary government. In this article, the focus on reporting by a primary government for its own financial position and operations, as well as those of its component units, regardless of whether the primary government is or is not a component unit of another primary government.

7 GASB Cod. Sec. 2100.122.

8 GASB Cod. Sec. 2100.126.

9 GASB Cod. Sec. 2100.127.

10 An investment is an asset that is held by a government "primarily for the purpose of income or profit" that "has a present service capacity based solely on its ability to generate cash or to be sold to generate cash," meaning it is not used in the provision of any government services (GASB Cod. Sec. I50, "Investments," paragraph .103).

11 GASB Cod. Sec. 2100.138.

12 As mentioned in footnote 4, a primary government should include a not-for-profit corporation as component units even if it is not financially accountable for the nonprofit, if the nature of the relationship would make financial statements of the primary government misleading if the not-for-profit were excluded. GASB standards require inclusion of a not-for-profit corporation as a component unit, regardless of financial accountability, when the not-for-profit's resources are held entirely or nearly entirely for the direct benefit of the primary government, the primary government (including any of its component units) can access a majority of those resources, and the resources held by the individual not-for-profit to which the government has access is significant to the primary government (GASB Cod. Sec. 2100.140). However, in these examples, the city is financially accountable for the non-for-profit organizations.

13 For more information on identifying and reporting fiduciary component units, please refer to accounting articles in the August 2018 and April 2020 issues of Government Finance Review.

14 GASB Cod. Sec. 2600, "Reporting Entity and Component Unit Presentation," paragraph .105.

15 Pension and OPEB plans do not fall into this category, as they are fiduciary component units.

16 GASB Cod. Sec. 2100.138.

17 See the discussion of the display of component units for an explanation as to why this would be reported as a special revenue fund.

18 See GASB Cod. Sec. 2200, "Annual Comprehensive Financial Report," paragraph .159. for threshold calculation.

19 General funds of blended component units are reclassified as major or nonmajor special revenue funds.

20 GASB Cod. Sec. 2600.108.