

▶ **The Appropriate Generally Accepted Accounting Principles
For CSU Auxiliary Organizations**

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PURPOSE AND BACKGROUND

This updated report is both commentary and analysis. It was originally commissioned in 1998 by the *Auxiliary Organizations Association (AOA)* Executive Committee at the request of its Accounting Committee. Its sole purpose was to assist AOA member-auxiliary organizations determine which subset of generally accepted accounting principles (GAAP) should be applied. An organization must make this determination as the first critical step in preparing for and having financial statements audited.

This report is based upon current national accounting industry standards and guidance issued through formal board pronouncements at the time of this revision. Accordingly, readers are cautioned that the comments, analysis and conclusions in this revised Report should be evaluated in light of later pronouncements. Report conclusions are drawn from the analysis, but are those of the authors, not the AOA.

The good news is that there are only two GAAP subsets that may be applicable to an auxiliary organization; the bad news is that choosing the wrong subset has

consequences for both the independent auditor and the client. Failure of the auditor to recognize that its client has adopted the wrong GAAP violates auditing and professional ethics standards that could lead to sanctions. For the auxiliary organization, its financial statements will not comply with the proper GAAP, and inappropriate accounting requirements may be triggered. Thus, the determination is a signal step in the independent auxiliary organization audit process.

PRELIMINARY CONSIDERATIONS

Under California law, each auxiliary organization must engage a qualified independent accountant to annually audit the organization's financial statements.¹ The auditor, in turn, is held to certain standards and practices set by the American Institute of Certified Public Accountants' (AICPA) in performing the independent audit and issuing reports.

In 1992, the AICPA established two distinct GAAP hierarchy sets: one for state and local governmental entities, and the other for non-governmental organizations.²

To apply the proper GAAP hierarchy (subset), an auxiliary, as a nonprofit organization (NPO), should evaluate and determine whether it is governmental or non-governmental. That determination cannot be left to the auditor. Deciding the appropriate GAAP subset has also received heightened attention as a result of the implementation of *GASB Statement No. 14, The Financial Reporting Entity*. GASBS 14 [now

¹ California Education Code Section 89900(a).

² The *Governmental Accounting Standards Board (GASB)* as the primary standards-setting authority for GAAPs applied to governmental organizations, while the *FASB (Financial Accounting Standards Board)* pronouncements set GAAPs for nongovernmental organizations.

codified] has caused governmental entities to include various NPOs in their financial reports, and to reconsider whether these NPOs are government organizations.³

Thus, the “GASB vs. FASB” GAAP issue arises, in part, out of a need to obtain auxiliary organization financial information for CSU consolidated-reporting purposes. Each auxiliary organization is required to submit annual financial statements in a specified format to the Chancellor’s office, irrespective of which GAAP subset an auxiliary determines appropriate for its corporate accounting and for financial reporting. Some GAAP subset decisions appear to stem from perceived financial consequences of complying standards in one hierarchy vs. the other.⁴ While the desired GAAP subset may vary depending on financial consequences of complying with recent FASB standards, it would not be appropriate to simply “elect” one over the other. The subset determination should be a function of applying requisite criteria to facts and circumstances, and should not vary based on desire or external influences.

ANALYSIS

The Financial Standards Evolution

In August 1995, GASB issued *Statement No. 29, The Use of Not-for-Profit Accounting and Reporting Principles by Governmental Entities*, to provide **interim** guidance to government agencies attempting to implement GASBS 14.

³ Chancellor’s Office Coded Memoranda BF 96-02 (March 1996) and AD 97-06.

⁴ For example, compliance with *FASB Statement 106, Employers’ Accounting for Postretirement Benefits Other Than Pensions* has been cited as a reason for going to the GASB GAAP subset.

GASBS 29 also attempted to address questions about applying FASB Statements 116 and 117 (*Accounting for Contribution Received and Contributions Made and Financial Statements of Not-for-Profit Organizations*, respectively) to proprietary activities - those usually considered to business-type functions, rather than not-for-profit. A number of GASBS 29 provisions have since been amended or superseded (GASB 34, reporting component units, and 62, codifying reporting standards), but, for the purposes of this analysis, the GASBS 29 Appendix A still seems relevant.

The CSU initially expanded the use of consolidated financial reporting for purposes not directly related to compliance with accounting or financial standards. For example, the information submitted each year by the CSU for the Integrated Postsecondary Education Data System (IPEDS) would be more comprehensive and reflective of the system’s financial size and condition, if specific auxiliary organization financial data could be included on the IPEDS survey form. More recent GAAP standards have resulted in the full integration of auxiliary organization financials into CSU financial reporting.⁵

Historically, and consistent with the application of nonprofit accounting and financial reporting standards, the auxiliary organizations within the CSU have come under the FASB. Each auxiliary organization is required under Board of Trustees regulations and the California Education Code to complete an annual independent audit. This requirement stems from a public policy rationale that dates from the original statutory authority for auxiliary organizations that these are separate legal

⁵ CSU GAAP Reporting Manual, 2013, Chap. 8.

and distinct entities from their host campus.

Auxiliary Organizations: Governmental or Nongovernmental?

GASBS 29 tried to get at two somewhat related situations:

First, there exists a diverse host of separate organizations with some official ties to state and local governmental entities. Many of these ancillary entities are incorporated as nonprofit, tax exempt corporations, and have been following nongovernmental accounting and financial reporting principles.

Secondly, some governmental agencies have either directly, or indirectly through ancillary entities, been following not-for-profit accounting and financial reporting principles for business-type activities (proprietary activities or funds). We are not concerned in this Report with the proprietary activities issue.

There are compelling reasons why auxiliary organizations should be included within the CSU financial reporting structure. The CSU, as a financial reporting entity, should report on a comprehensive basis to include: itself (as the “primary government”); any organizations for the primary government that is financially accountable (not auxiliary organizations), and; other organizations for which the nature and significance of their relationship with the primary government are such that exclusion would cause the reporting entity's financial statements to be misleading or incomplete. These latter organizations are referred to as “component units” (auxiliary organizations are component units of the primary government, the CSU). It is imperative that auxiliary organization managers draw and understand the distinction of the auxiliary

organization as a “component unit” of the CSU for its consolidated financial reporting purposes, versus a characterization of the auxiliary organization itself as a “governmental entity” that would trigger the application GASB standards for its own financial statements. **All auxiliary organizations should be viewed as component units, but that status should not drive a GAAP subset determination.**

In attempting to sort out this complex issue, the GASB wisely ducked a strict definition of a “governmental entity.” Instead, GASBS 29 includes, in “background information” (Appendix A, Paragraph 14), the following guidance:

Determining whether an entity is governmental is a matter of judgment based on an assessment of all of the facts and circumstances, including the entity's creation, structure, and operation - there are no authoritative standards that define when an entity is a government.

This guiding narrative then references a November 1993 GASB staff paper titled, “*Applicability of GASB Standards*” (GASB Staff Paper),⁶ as an **advisory** reference, “...intended to be helpful in resolving questions about whether a particular entity should follow the hierarchy of accounting standards applicable to state and local governmental entities or the hierarchy applicable to nongovernmental entities.” Importantly for this analysis, the GASB Staff Paper discusses useful characteristics to be considered in evaluating whether an entity is governmental or nongovernmental.

⁶ “*Applicability of GASB Standards*,” November 1993, GASB Staff paper (2643i-11\93).

The GASB Staff Paper was supplanted by a more concise criteria expressed in revised AICPA guidance. But, as will become evident as this analysis progresses, the evaluation methodology in the GASB Staff Paper may have some relevance in close determination cases.

The current edition of the AICPA “Not-for-Profit Organizations” Audit and Accounting Guide (AAG) draws a distinction between certain “nongovernmental not-for-profit organizations” and those classified as “governmental organizations.”⁷ The provision first generally defines governmental organizations as including “public corporations” (citing an extensive *Black’s Law Dictionary* definition), as well as “bodies corporate and politic.” Then more discerning criteria are expressed. Other organizations are governmental organizations if they have one or more of the following characteristics:

- a. Popular election of officers or appointment (or approval) of a controlling majority of the members of the organization’s governing body by officials of one or more state or local governments;
- b. The potential for unilateral dissolution by a government with the net assets reverting to a government; or
- c. The power to enact and enforce a tax levy.

The AICPA criteria closes with a

⁷ At Guide Paragraph I.03. This provision derives from joint GASB/FASB staff work approved by the chairman of both boards. Source: Interview with Karl Johnson, GASB staff assigned to this policy area.

qualified governmental organization *presumption* for those having the ability to issue directly (rather than through a state or municipal authority) debt that pays interest exempt from federal taxation. The qualification is that this *presumption* may be rebutted (overcome) if an organization **only** possesses the tax-exempt debt issuance ability **and** none of the other governmental characteristics cited above -- if the determination is supported by compelling, relevant evidence.

This guidance results in a “three-tier” test.

First-Tier Test:

There are three (3) categorical governmental-organization characteristics. The presence of any one of them would lead to a GASB GAAP subset determination.⁸

Some auxiliary organizations have governing bodies whose controlling majority is in the hands of the campus president. These come in several combinations -- and all would seem to call for a GASB GAAP subset determination. See more on this in Conclusion below.

Neither the Education Code nor the California Nonprofit Corporation Law authorizes auxiliary organizations to enact and enforce a tax levy.

Auxiliary organization articles of incorporation are required to include a provision that upon dissolution, net assets, other than trust funds, shall be distributed to a successor approved by the (governing board), campus president and the

⁸ These appear as sole criteria in CSU *Qualifications Review Questionnaire for Proposed Audit Firm* (Preface).

Chancellor.⁹ *Disposition of Assets* clauses are required to be in place as a provision in auxiliary organization operating agreements. The clauses now require the auxiliary organization to maintain the dissolution provision in the articles of incorporation and if it alters asset distribution at dissolution, the agreement/lease terminates and net assets become the property of the Trustees. A November 14, 2011 change to the model auxiliary organization operating agreement now includes an “alternative” clause that gives full discretion to the CSU to transfer all assets to a qualified successor upon breach or termination.¹⁰

Does this dissolution-asset distribution framework constitute “the potential for unilateral dissolution” contemplated by the *first-tier test*? The plain meaning of “unilateral dissolution” is that a campus president or the CSU must have the preemptory power to dissolve the auxiliary organization. With the new *Disposition of Assets* provision included in such a signed operating agreement, the CSU may simply terminate or declare it breached to arguably reach a unilateral dissolution state.

Auxiliary organizations having none of the above three categorical characteristics must move further into the determination-analysis by examining the qualified presumption, or second-tier test.

Second-Tier Test:

For auxiliary organizations there is a *statutory* framework declaring that “(a)ll bonds, notes, borrowings, or other evidences of indebtedness of an auxiliary organization and interest thereon or income therefrom are exempt from all taxation in

the state...”¹¹

The U.S. Internal Revenue Service issued a 1997 written determination sought by the CSU¹² to the effect that a certain auxiliary organization was an “instrumentality” of the State of California for purposes of Section 103 of the Internal Revenue Code. This status suggests that the auxiliary organization might be able issue tax-exempt governmental obligations in its own name. A close reading to the salient facts associated with this determination reveals that the university President had control over the auxiliary organization’s governing board composition. This is one of the first-tier test categorical characteristics, and suggests that the IRS drew its “instrumentality” conclusion in part on this feature. In any event, this 1997 determination may not represent sufficient independent authority applicable to other auxiliary organizations sufficient to trigger the qualified “governmental entity” presumption (second-tier test).

The CSU *System-wide Revenue Bond* (SRB) program has effectively subsumed auxiliary tax-exempt debt financings.¹³ The SRB framework does not, however, preclude an auxiliary organization from directly issuing tax-exempt debt (with appropriate approvals), and there remains the IRS framework for Section 501(c)(3) organizations to qualify for such financing structures.¹⁴

¹¹ Cal Ed. Code Section 89912.

¹² PLR-109974-97 is, by its terms, applicable only to the entity seeking the ruling, and may not be used or cited as precedent.

¹³ See Executive Order No. 994, dated October 23, 2006.

¹⁴ Rev. Rul. 63-20 and Rev. Proc. 82-26.

⁹ Cal Code of Reg., Sections 42500(k) and 42600(b).

¹⁰ At: http://auxiliary.calstate.edu/?page_id=1195

Third-Tier Test:

In order to complete this determination-analysis model, assume, hypothetically, there are facts that an auxiliary has the “ability to directly issue tax-exempt debt,” but it possesses none of the first-tier test categorical characteristics. Is there other compelling, relevant evidence to be considered to overcome the second-tier test rebuttable presumption that it is a governmental organization? What might such factors be?

Without any more detailed AICPA criteria to guide on, the authors suggest that the GASB Staff Paper has some practical tools for working through *third-tier test* situations.

The substantive portions of the GASB Staff Paper trace the same three-tier test model outlined above. At the third level, the Staff Paper suggests several “government characteristic” factors be considered to help in the determination assessment. Of the six “governmental-character” factors identified, only two have any conceivable application to auxiliary organizations (that have not been discussed above), and they deserve additional scrutiny. The documented **absence** of these remaining factors would likely serve to rebut the second-tier test presumption. But if there are facts and circumstances that point to these factors, then the governmental organization presumption would seem to be reinforced.

Legal Decisions within the Jurisdiction.

Under this factor, the GASB Staff Paper urges the examination of court rulings within the state to help determine whether a similarly organized entity is governmental.

The California statutory and CSU regulatory framework does certainly authorize the provision of certain campus functions through auxiliary organizations.¹⁵ This framework and a somewhat meager line of case law, makes it clear that auxiliary organizations are not state agencies,¹⁶ and rebut the presumption.

Managerial Control. The GASB Staff Paper concludes that the only other evidence of “governmental character” an entity could possess which might be an indicator relates to the degree to which the governmental agency manages the entity in question. This is the “professional-judgment” level of analysis, since degrees-of-control can run from the overt requirements to subtle relationships, like:

- a. Ability of a governmental entity to designate day-to-day operating management of the nonprofit corporation;
- b. Requirement that an employee of a governmental entity serve as the nonprofit’s CEO;
- c. Imposition on the nonprofit corporation by statute of day-to-day operating requirements so similar to requirements imposed on governmental agencies as to warrant a conclusion that the organization is itself a government; and,
- d. Provision that the nonprofit corporation's properties and responsibilities revert to the governmental entity after debt

¹⁵ *Cal Ed Code* Section 89901 and *Cal Code of Reg.*, Section 42500.

¹⁶ *Wanee v. Board of Directors*, 56 Cal. App. 3d 644, 128 Cal Rptr. 526 (1976).

issued by the governmental entity to finance facilities used by the nonprofit corporation has been paid.

An additional source of advisory *tier-three* guidance comes from a somewhat tangential source. In late 2012 the Internal Revenue Service issued advance notice of proposed rules to define a “governmental plan” under tax code Section 414(d).¹⁷ IRS's draft regulation would use a facts-and-circumstances test to identify “major factors” and “other factors” that qualify a retirement plan as a governmental plan not subject to minimum participation and nondiscrimination and rules or provisions of the Employee Retirement Income Security Act. A series of examples are offered with each of the proposed factors, and these represent potential tests to help judge the presence or absence of rebuttal circumstances.

The relative presence or absence of such *tier-three* factors should be carefully documented and weighed under the “compelling, relevant evidence” standard to be of any meaningful use in a close determination analysis.

CONCLUSION

Using the current *AICPA* authoritative criteria, from our analysis, the only clear basis for determining that the *GASB* subset should **categorically** apply to a campus auxiliary organization is when the president appoints or approves a controlling majority of the governing board.

A determination-analysis required to focus on the “controlling majority” criteria

should include a detailed interpretation of the organization’s bylaws and policies, particularly governing board composition, size (actual and any limits), how board members are designated, nominated and elected. Any judgment about the campus president’s “controlling majority” of the board can even turn on how certain terms or phases are used. Bylaws in this realm can change, suggesting that such changes should lead to GAAP determination reassessment.

Determining the GAAP subset applicable to a particular auxiliary organization may not be simple or clear-cut.

The *first-tier* test should also consider whether a “unilateral dissolution” characteristic exists if the operating agreement contains the alternative “disposition of assets” provision. The transfer of all organization assets would plainly lead to a winding up and dissolution.

The GAAP determination decision should be a matter of judgment, applying the three-tier test presented above to the facts and circumstances (including the entity’s creation, structure and operation), and result from a documented assessment.

Accounting literature suggests that auditors should consider the GAAP subset determination to be a legal matter. It is more than that. As described in this Report, the potential consequences from using the wrong rules will likely be borne by all concerned, including the audit firm. The organization needs to take ownership or the determination process and in the outcome.

As noted in the opening remarks, subsequent authoritative guidance may alter the determination criteria -- with consequences that may be relevant to

¹⁷ http://www.irs.gov/pub/irs-tege/reg_157714_06.pdf

auxiliary organizations.

The initial applicability of GASB rules to those organizations meeting the criteria for GASB accounting was for the year ending June 30, 1997. For auxiliary organizations that did not undertake a complete and documented determination, management should take the lead by initiating (with governing board notice/approval, as appropriate) a GAAP hierarchy determination reassessment, involving auxiliary organization and campus financial staff, the independent auditor, and legal counsel. The assessment results should be documented in a report to the governing board and university president. The report should include a statement of the determination required, a summary of the assessment methodology and results, and a determination recommendation. Board policy or custom will dictate whether management or the governing body makes the formal determination. A formal notice of the determination (report appended) should be forwarded to the auditor, legal counsel, and to the university chief business officer.