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20 May 2020

Agenda request – Evaluating whether a for-profit entity has a controlling financial interest in a not-for-profit entity

Dear Mr. Kuhaneck:

Ernst & Young LLP is submitting an agenda request to the Financial Accounting Standards Board (FASB) to address how a for-profit entity evaluates whether it consolidates a not-for-profit (NFP) charitable foundation.

Background

There are many types of NFPs that could be formed by a for-profit entity, including charitable foundations that make grants for educational, research or other purposes. Some for-profit entities may sponsor charitable foundations that are tax-exempt under Section 501(c)(3) of the Internal Revenue Code, through which they conduct their charitable giving, instead of making contributions to unaffiliated NFPs.

NFP charitable foundations sponsored by a for-profit entity are often structured with a sole corporate member that is usually the sponsoring entity (or an officer of the sponsor). When the for-profit entity is the NFP's sole corporate member, it usually appoints all of the NFP's board members who are employees of or other related parties to the for-profit entity. As a 501(c)(3) organization for federal income tax purposes, the NFP is generally prohibited from making direct transfers of monetary resources or benefits back to the for-profit entity. In addition, for an NFP to qualify for a 501(c)(3) designation, its governing documents generally state that upon its liquidation or dissolution, its assets must be distributed to another NFP or granted in accordance with the NFP's original purpose. That is, the assets may not be returned to the sponsoring for-profit entity.



Issue

As long as a for-profit entity is not using an NFP to circumvent the Variable Interest Model, it evaluates the NFP for consolidation under the Voting Model (i.e., the general subsections) in Accounting Standards Codification (ASC) 810, *Consolidation*.¹ ASC 810-10-15-8 to 15-8A states that, under the Voting Model, the usual condition for a controlling financial interest is ownership of a majority voting interest of a corporation or a majority of kick-out rights for a limited partnership. The **power to control** may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other stockholders or court decree.

In addition to the guidance in the Voting Model in ASC 810-10, Rule 1-02(g) of Regulation S-X states that for Securities and Exchange Commission (SEC) registrants “the term control (including the terms controlling, controlled by and under common control with) means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting shares, by contract, or otherwise.”

Rule 3A-02(a) of Regulation S-X further states:

“Generally, registrants shall consolidate entities that are majority owned and shall not consolidate entities that are not majority owned. The determination of majority ownership requires a careful analysis of the facts and circumstances of a particular relationship among entities. In rare situations, consolidation of a majority owned subsidiary may not result in a fair presentation, because the registrant, in substance, does not have a controlling financial interest (for example, when the subsidiary is in legal reorganization or in bankruptcy). In other situations, consolidation of an entity, notwithstanding the lack of technical majority ownership, is necessary to present fairly the financial position and results of operations of the registrant, because of the existence of a parent-subsidiary relationship by means other than record ownership of voting stock.”

Rule 3A-02 also states that “there is a presumption that consolidated statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one entity directly or indirectly has a controlling financial interest in another entity.”

We understand there is diversity in practice in how the Voting Model is applied when evaluating whether a for-profit entity has a controlling financial interest in an NFP charitable foundation, given the unique characteristics of an NFP compared with those of a for-profit entity. While the Voting Model defines a controlling financial interest in terms of voting rights that convey power, it does not further define the characteristics of a “financial interest” that provides such rights. Accordingly, it is unclear how a for-profit entity should evaluate whether it has a financial interest in an NFP in determining whether it has a controlling financial interest.

¹ ASC 810-10-15-17(a).

Although the focus of this discussion is on sponsors of NFP charitable organizations, similar considerations may apply to other NFPs established by a for-profit entity (e.g., political action committees, homeowners or other realty-based associations, “points”-based associations).

We are aware of two primary views that are applied in practice to determine whether a for-profit entity has a controlling financial interest in an NFP. One primary view is that only the guidance in the Voting Model in ASC 810 should be applied. The other primary view is that the guidance in ASC 958-810, *Not-for-Profit Entities – Consolidation*, should be applied by analogy.

Consolidation evaluation under ASC 810

View A: A for-profit entity that has the power to control the NFP has a controlling financial interest under ASC 810.

Proponents of this view interpret the guidance under the Voting Model in ASC 810-10 as requiring consolidation when the sponsor has the power to make decisions for the not-for-profit charitable foundation (e.g., the sponsor has control over the NFP’s board of directors through its sole corporate membership). Proponents of this view also may look to the guidance in Rule 1-02(g) of Regulation S-X, which states that, for SEC registrants, the term “control” means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting shares, by contract **or otherwise**.

View A': A for-profit entity does not have a controlling financial interest under ASC 810 if it does not have an ownership interest representing a residual or other economic interest in the net assets of the NFP.

Proponents of this view believe that the sponsor does not have a controlling financial interest, even if the sponsoring for-profit entity appoints the board of directors, because such rights do not stem from shares that provide “ownership rights.”² Furthermore, any decision making is limited by US tax law, which imposes significant limits on the ability to generate monetary benefits (i.e., financial or economic benefits) to the sponsor (unlike an ownership interest in a for-profit entity). Supporters of this view point to the concepts discussed in the FASB’s 1999 *Exposure Draft on Consolidated Financial Statements: Purpose and Policy*, although the guidance is not authoritative. In paragraphs 75 through 76 of this exposure draft, the FASB reasoned that even if a majority of the charitable foundation’s board members consists of officers and directors of the sponsoring for-profit corporation or is appointed by the sponsoring for-profit corporation, the board’s ability to direct the charitable foundation on behalf of the for-profit corporation is limited by US tax law. The powers of the board of directors of a charitable foundation are similar to the limited powers and responsibilities of a trustee, which, the exposure draft also concludes, generally would not consolidate a trust.³

² See paragraph 57 of the FASB’s 1999 *Exposure Draft on Consolidated Financial Statements: Purpose and Policy*.

³ See paragraphs 71 through 74 of the above exposure draft.



Application of the guidance in ASC 958-810 by analogy

In the absence of specific guidance in ASC 810 on how to determine whether the for-profit entity has a controlling financial interest in an NFP, some have applied the guidance in ASC 958-810 by analogy since it contemplates some of the unique characteristics of an NFP.

ASC 958-810 addresses how an NFP reporting entity should determine whether it has a controlling financial interest in another NFP. Under ASC 958-810-25-2, direct or indirect ownership of a majority voting interest or the sole corporate membership of an NFP, like the ownership of a majority interest of a for-profit entity, generally provides a controlling financial interest. ASC 958-810-25-3 also generally requires an NFP reporting entity that controls the NFP through a majority voting interest in the board by means other than ownership or sole corporate membership and has an economic interest⁴ in another NFP to consolidate that NFP.

In determining whether a for-profit entity has a controlling financial interest in an NFP, some evaluate whether the for-profit entity is (1) the sole corporate member or controls the board of directors (including the ability to appoint and replace directors) and (2) has an economic interest in the NFP, as defined in ASC 958-810. However, there are diverse views on how to interpret this term because the definition is unclear.

View B: A for-profit entity applies the definition of an economic interest in ASC 958-810 by analogy and interprets the term narrowly.

Proponents of this view interpret “economic interest” narrowly and only consider explicit interests (e.g., explicit guarantees of debt, commitments to fund). Some believe that even an explicit commitment to fund an NFP may not create an economic interest if it is voluntary and nonbinding (i.e., the for-profit entity can stop funding the NFP without economic penalty from a third party).

Those supporting a narrow view of the term also may point to the concepts discussed in the FASB’s 1999 exposure draft, which states that a “corporation or other entity organized for profit, however, usually is precluded by law from (a) owning or otherwise having a residual or other economic interest in the net assets of a corporation that is established to achieve a charitable or other nonprofit public purpose.” Accordingly, even when analogizing to ASC 958-810, some believe that a for-profit corporation does not hold an economic interest in an NFP and, thus, does not have a controlling financial interest in an NFP.

⁴ This term is defined in ASC 958-810 as follows:

A not-for-profit entity's (NFP's) interest in another entity that exists if any of the following criteria are met:

- a. The other entity holds or utilizes significant resources that must be used for the purposes of the NFP, either directly or indirectly by producing income or providing services.
- b. The NFP is responsible for the liabilities of the other entity.

See paragraph 958-810-55-6 for examples of economic interests.



View B': A for-profit entity applies the definition of an economic interest in ASC 958-810 by analogy and interprets the term broadly.

Proponents of this view interpret "economic interest" broadly and consider implicit benefits and obligations (e.g., an implicit obligation to provide ongoing funding, back-office support, the "intangible" benefits of positive public relations for having established a charitable foundation). They also may consider whether the NFP plans to receive funding or grants from parties that are unrelated to the for-profit entity and whether the NFP is considered to be fully funded at inception.

Request

In summary, it is unclear how a for-profit entity should determine whether it has a controlling financial interest in an NFP charitable foundation when applying the Voting Model in ASC 810, including whether a financial or economic interest is required, and if so, how that term should be interpreted in this context. We recommend that the FASB add a project on this issue to its agenda to reduce diversity in how the guidance is applied in practice.

If you have any questions, please contact Paul Beswick or Josh Forgione.

Very truly yours,

Ernst + Young LLP