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LETTER OF COMMENT NO. 13

Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856
director@fasb.org

File reference No. 1500-200, *Not-for-Profit Organizations: Goodwill and Other Intangible Assets Acquired in a Merger or Acquisition*

We appreciate the opportunity to comment on the proposed Statement, *Not-for-Profit Organizations: Goodwill and Other Intangible Assets Acquired in a Merger or Acquisition*. We support the issuance of a final Statement that would eliminate from Statement 142, *Goodwill and Other Intangible Assets*, the deferral for not-for-profit organizations and would

- Improve financial reporting by applying a single standard to all intangible assets acquired by a not-for-profit organization, regardless of whether those assets were acquired as part of a merger or acquisition
- Provide an exception to the fair value based evaluation for goodwill assigned to reporting units primarily supported by contributions and returns on investments. However, we recommend requiring the immediate write off of goodwill that would be assigned to reporting units primarily supported by contributions and returns on investments.

Our comments are described more fully in the following detailed responses to the Board's questions on the Exposure Draft. Although we have recommended the immediate write off of goodwill that would be assigned to reporting units primarily supported by contributions and returns on investment, we have provided suggestions for clarifying the proposed guidance on the qualitative evaluation.

Accounting for identifiable intangible assets

Question 1—Are the accounting requirements for intangible assets appropriate, understandable, and sufficient for identifiable intangible assets acquired by a not-for-profit organization in a merger or acquisition? If not, why and what alternative do you suggest?

We believe that the accounting requirements for intangible assets in the proposed standard are appropriate, understandable, and sufficient. Not-for-profit organizations already apply Statement 142 to account for intangible assets acquired outside of a merger or acquisition of a business or another not-for-profit organization. Therefore, we believe that the proposed Statement would improve financial reporting by applying a single standard to all intangible assets acquired by a not-for-profit organization, regardless of how those assets were acquired.

Accounting for goodwill

Question 2— Is the departure from the goodwill impairment evaluation in Statement 142 appropriate for reporting units that are primarily supported by contributions and returns on investments? If not, why and how should goodwill be evaluated for impairment?

Goodwill recognition and subsequent accounting

The FASB has proposed that not-for-profit organizations should measure and recognize as an asset the amount of goodwill purchased in a merger or acquisition. Under the proposed standard, that asset would not be amortized but would be evaluated for impairment, depending on the nature of the reporting unit to which it is assigned. The proposed Statement would require not-for-profit organizations to apply a new qualitative evaluation for goodwill assigned to reporting units that are primarily supported by contributions and returns on investment, and to apply the existing fair-value-based test in Statement 142 for goodwill assigned to other reporting units.

We share the Board's concern about the potential cost and difficulty of determining the fair value of acquirees in mission-driven transactions, which may not be designed to maximize a return to investors, and of reporting units that lack the characteristics of a business. Therefore, we support the proposal to measure only the amount of goodwill purchased and to provide an exception to the fair-value-based impairment test for goodwill assigned to reporting units primarily supported by contributions and returns on investments. However, we have significant concerns about the accounting proposed for goodwill assigned to such reporting units, and therefore, we considered the amortization or immediate write-off of goodwill as possible alternatives to the proposal.

For both the acquisition date and subsequent periods, we considered the representational faithfulness and decision usefulness of the information that would be provided by the various accounting alternatives, in addition to the cost and complexity of providing it.

Representational faithfulness

We believe that goodwill acquired in a merger or acquisition by a not-for-profit organization would meet the definition of an asset and acknowledge that, absent a catastrophic event, its immediate write-off probably would understate the acquisition date balance sheet and not recognize an impairment loss in the period in which it occurred. However, we do not believe that the proposed qualitative evaluation of goodwill carried without amortization could be relied on to continue to reflect economic reality in subsequent periods on a consistent basis.

Under the proposed Statement, performance of a qualitative evaluation would require identification of events that would indicate that goodwill had become significantly impaired. Impairment events would be identified based on considering the reasons goodwill arose in a transaction. Paragraph 35 of the proposed Statement provides examples of impairment events based on identified reasons for a merger, including, "If a reason for a merger was to acquire certain integrated tangible or identifiable intangible assets owned by the acquiree, an impairment of those assets is an impairment event for

goodwill.” If the integrated tangible or identifiable intangible assets in that example were finite-lived and significant enough to the acquirer that their impairment would trigger full write-off of the carrying amount of related goodwill, then perhaps the related goodwill was itself primarily finite-lived. The finite-lived nature of the acquired goodwill indicated in those circumstances raises the question of whether amortization of that goodwill over a period related to the primary reasons for the merger might reflect economic reality better than nonamortization.

The FASB adopted nonamortization of goodwill in Statement 141 only after developing a goodwill impairment test that is more robust than the test in Statement 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, thereby enhancing the representational faithfulness of the goodwill accounting after acquisition and improving the decision usefulness of a recognized impairment. In paragraph B99 of Statement 142, the Board reasoned that “an adequate impairment test will provide financial information that more faithfully reflects the economic impact of acquired goodwill on the value of an entity than does amortization of goodwill.” Under the qualitative evaluation of goodwill carried without amortization, goodwill would be carried at either 100 percent of acquisition-date value or entirely written off when there is evidence of significant impairment. In contrast, a Statement 142 fair-value-based goodwill impairment test can measure and recognize partial impairments, providing a more faithful representation of the economic condition, and an indication of the degree of impairment. Because the qualitative evaluation has no mechanism for measuring and recognizing partial impairments, the carrying amount of the goodwill could be significantly overstated for an unknown period of time before the impairment event occurred, and the impairment losses may not be recognized in the period in which they occur. Therefore, the amount and timing of the impairment recognized under the proposed accounting would only indicate the fact that an impairment event had occurred, information we think is likely to be otherwise evident.

Decision usefulness

Although rejecting the immediate write-off of goodwill, as discussed in paragraphs B132— B138 of the proposed Statement on mergers and acquisitions by not-for-profit organizations, the Board has identified limitations on the decision usefulness of a not-for-profit organization’s recognition of goodwill in its financial statements. In paragraph B132, the Board concluded that, for making resource allocation decisions, donors may find goodwill information to be of limited use, and, instead of goodwill, creditors “first look to information about assets that can be directly used to settle obligations.” The Board also concluded that information other than goodwill information provides a better understanding of an organization’s service efforts and accomplishments.

Paragraph B135 of the proposed Statement describes the Board’s consideration of how goodwill could be reported to help users of the financial statements distinguish changes in resources that are related to operations from those that are not, information about the nature and relationship between inflows and outflows of resources (a performance indicator established by Concepts Statement 4 for nonbusiness entities). Paragraph 35 states:

The Board is not convinced that reporting goodwill on the statement of financial position or the impairment of goodwill in the statement of activities meets that objective in Concepts Statement 4 any better than alternative methods. For example, if upon acquisition goodwill was immediately written off, users of financial statements could distinguish that event as one that was not related to operations if the Board was to require display of the write-off separately from revenues, expenses, gains, and losses.

The Board rejected the immediate write off of goodwill after acquisition for reasons outlined in paragraph B27 of the proposed Statement, including the following:

Although the impairment evaluation is qualitative for reporting units that are primarily supported by contributions and returns on investments, evaluating goodwill for impairment after the acquisition is consistent with Statement 142. The impairment of goodwill would provide decision-useful information that is comparable and understandable.

We believe the usefulness of information that would be provided by the proposed qualitative evaluation of goodwill carried without amortization would be limited. The previously described limitations on the qualitative evaluation's ability to faithfully represent economic reality would also limit the usefulness of the resulting information. In some circumstances, we believe the result would be carrying an overstated asset so that the recognition of an impairment loss, after it has occurred (gradually over-time) can alert financial statement users to the occurrence of an event that might be otherwise evident. Furthermore, we believe accounting for goodwill as an indefinite-lived asset would presume the recognition of replacement goodwill. Although recognition of replacement goodwill is consistent with the fair-value-based impairment test, the presumption of an indefinite life would be inconsistent with the disclosure of impairment indicators that appear to reflect a finite-lived asset.

Conclusions and recommendation

We believe that each alternative considered—the qualitative evaluation of goodwill carried either with or without amortization, or immediate write-off— would involve some compromise with respect to the faithful representation of economic reality. We believe that the proposed accounting would more faithfully represent goodwill information on the acquisition date, but may not be adequate for subsequent periods. We think that goodwill amortization based on an analysis of the reasons for a merger could address those concerns by providing a better reflection of economic reality after acquisition in some circumstances. However, determining when and over what period amortization would add complexity to the accounting. The qualitative evaluation for impairment would still be necessary for goodwill subject to amortization.

We recommend the immediate write off of goodwill that would be assigned to reporting units primarily supported by contributions and returns on investments to reduce the cost and complexity of accounting for goodwill. Although we acknowledge that goodwill meets the definition of an asset on the acquisition date, we do not believe that the proposed qualitative evaluation of goodwill carried without amortization after acquisition would consistently provide information that more faithfully represents economic reality than would either the amortization of goodwill based on reasons that gave rise to goodwill in a merger or the immediate write-off of that goodwill. We also believe that the proposed goodwill accounting would provide information of limited usefulness to donors, creditors and other users of the financial statements, while adding cost and complexity for preparers.

Assigning and reassigning assets, liabilities, and goodwill to reporting units

At its January 26, 2005, meeting, the Board made several decisions designed to clarify that the guidance on assigning or reassigning assets, liabilities, and goodwill to reporting units should not require an organization to determine the fair value of either an acquiree or a reporting unit for which the Board had provided a measurement exception. We do not think the proposed Statement fully reflects those decisions, as indicated in our specific comments on paragraphs 21, 29, and 31. The January 2005 decisions addressed specific provisions of Statement 142, but the proposed Statement is

based on the amendments to Statement 142 that were proposed in the June 30, 2005, exposure draft on business combinations. Therefore, it may have been unclear how the January 26, 2005, decisions would affect the amendments subsequently proposed as part of the business combinations project. In addition, for purposes of reducing the complexity and cost of the proposed standard, the Board subsequently extended the acquisition-date goodwill measurement exception to acquirees that are for-profit businesses. We suggest that the Board comprehensively revisit the proposed guidance for not-for-profit organizations to consider whether its application would be consistent with the accounting model adopted for not-for-profit organizations.

Paragraph 21, assigning goodwill. The first sentence in paragraph 21 says that goodwill should be assigned to reporting units in a manner similar to how it is recognized in a merger or acquisition by a not-for-profit organization. What follows the first sentence refers to determining the fair value of an acquiree and appears to be a description of the proposed accounting for business combinations rather than for mergers and acquisitions by not-for-profit organizations. Finally, the guidance on assigning goodwill to a reporting unit to which none of the assets acquired or liabilities assumed are assigned would require determination of the fair value of the reporting unit.

We suggest moving the footnote (2) reference to the end of the first sentence and adding a sentence to clarify that none of the subsequent guidance requiring the determination of the fair value of a reporting entity would apply to a reporting unit primarily supported by contributions and returns on investments. We also recommend that the remainder of the paragraph should reflect the accounting method applicable to not-for-profit organizations.

Paragraph 29, reorganization of the reporting structure. We do not think the proposed guidance on the reassignment of goodwill to reorganized reporting units appropriately reflects the decision described in the minutes of the January 26, 2005, Board meeting, as follows:

The Board decided that when all or part of a reporting unit that is supported primarily by contributions and returns on investments is to be integrated into one or more other reporting units, at least one of which is supported primarily by contributions and investment returns, the goodwill should be reassigned based on specific identification, if possible. Otherwise, the goodwill reassignment in the circumstances described should be based on the relative carrying amounts of the identifiable recognizable net assets reassigned.

In addition, we suggest the Board consider that the relative fair value basis for reassigning goodwill to two or more reporting units, at least one of which is primarily supported by contributions and investment returns, would require determining the fair value of the contribution-supported reporting unit(s). In those circumstances, the relative fair-value method of accounting may not be appropriate, regardless of the nature of the original reporting unit.

Paragraph 31, disposal of a portion of a reporting unit. Paragraph 31 does not reflect the January 26, 2005, Board decision that goodwill should be allocated based on the relative carrying amounts of identifiable net assets when the portion of the reporting unit to be disposed of, retained, or both is primarily supported by contributions and investment returns.

Question 3— Are the criteria for determining which impairment evaluation to apply appropriate, understandable, and sufficient? If not, why and how should the guidance be modified or clarified?

We believe that the nature of a reporting unit's primary support is an appropriate basis for identifying reporting units that are sufficiently different than a business to need an exception to the fair value based evaluation of goodwill.

Paragraphs 22, 23, and A2–A5 provide guidance on the initial determination of the nature of a reporting unit’s primary support that focuses primarily on how to consider forms and amounts of support, but not on the significance of the design of the reporting unit and management’s plans and expectations. Those factors are subsequently introduced in the proposed standard as relevant factors in assessing whether the nature of a reporting unit’s support has changed. We believe this narrow focus of guidance on the initial determination could be misunderstood. We think that the guidance in paragraphs 22, 23, and A2, as well as the examples in paragraphs A3–A5, could be enhanced to clarify that the determination of the nature of a reporting unit’s primary support should be based on how the unit is designed to be supported, based on an analysis of all relevant facts and circumstances. The forward-looking nature of the assessment, as illustrated in paragraphs 25 and A8 on assessing whether the nature of a reporting unit’s support has changed, would also be relevant to the initial determination of the reporting unit’s nature, as described in paragraphs 22, 23, and A2. Relevant information could include organizational structure, management budget, strategic plans and initiatives, and investments in infrastructure. Operating history would be relevant to the extent that it was expected to predict the organization’s future.

Qualitative evaluation

Question 4— Is the proposed qualitative evaluation operational for the intended reporting units and will it adequately identify an impairment of goodwill in the correct period? If not, why and how should the guidance be modified or what alternative evaluation would capture an impairment of goodwill on a more timely basis?

Consideration of the extent of impairment

Paragraph B27 in the proposed standard indicates that the Board believes that “a qualitative evaluation is more likely [than an immediate write-off of goodwill] to result in the recognition of a significant impairment in the period in which it occurs.” Although a qualitative evaluation, by definition and design, would not quantify the extent of a partial impairment, we think the concept of *significant* impairment would be relevant to a qualitative analysis, because an impairment event triggers total write-off. In paragraphs 33–36, applying the qualitative evaluation requires consideration of whether an event indicates that impairment has occurred not that *significant* impairment has occurred. However, paragraph 27 would require consideration of whether a change in the nature of a reporting unit’s primary support to contributions and investment returns indicates that goodwill is *significantly* impaired. We recommend that the guidance for identifying impairment events and for performing a qualitative evaluation require consideration of whether a *significant* impairment has occurred. For example, the impairment event in paragraph 35(c), which is based on a reason for a merger, would be “an impairment” of certain integrated tangible assets or identifiable intangible assets. Because impairment tests applicable to those assets are capable of identifying and measuring partial impairments, “an impairment” could be any amount between the carrying amount of the assets and zero. We think it would be important to identify when the impairment of the acquired assets would be significant enough to indicate that the related goodwill was sufficiently impaired to support recognizing a loss equal to 100 percent of the carrying amount of the goodwill.

Question 5— Is the guidance for identifying the triggering events appropriate, understandable, and sufficient? If not, why and how should the guidance be modified and are there additional examples that should be included?

As previously indicated, we think that the events identified should be expected to indicate that *significant* impairment has occurred.

Paragraph 35 provides examples of impairment events related to specific reasons why goodwill arose in a particular transaction. As written, we believe that the list sounds inappropriately prescriptive rather than illustrative. We recommend moving the guidance in paragraph 35 to Appendix A and clarifying that each of the examples represents a judgment rather than a rule. Real life judgments may be more nuanced, for instance, examples 35(a) and (b) could include a time component if the acquirer expected cross training and staff growth. We also think that an assessment of the relative significance of the reasons identified in a single acquisition could lead to a conclusion that the impairment indicated by a particular event would *not* be considered a significant impairment.

Question 6— If an identified triggering event occurs, do you agree with the measurement of the impairment loss (equal to the carrying amount of goodwill related to the acquisition within the reporting unit)? If not, why and what alternative do you suggest

The qualitative evaluation would require either no recognition or 100% recognition of the carrying amount of the identified goodwill as an impairment loss. As previously indicated, we have concerns about the proposed qualitative evaluation, but we do not think that it should be expected to provide a more precise impairment measurement. For example, we think that any recognition of a partial impairment using the qualitative evaluation would be arbitrary and misleading, implying a degree of measurement precision in the evaluation that does not exist.

Changes in the nature of a reporting unit's primary support

Question 7— Is the guidance for determining what method of impairment should be applied when there is a change in the nature of a reporting unit's primary support appropriate, understandable, and sufficient? If not, why and how should the guidance be modified or clarified?

We think that guidance is sufficient.

Benefits and costs of the proposed requirements

Question 8— What costs do you expect to incur if the requirements of the proposed Statement were issued as a final Statement? What benefits do you expect? How could the Board further reduce the related costs of applying the requirements of the proposed Statement without significantly reducing the benefits?

(See our comments under Question 2).

We would be pleased to discuss our comments and recommendations with Board members or staff. Please direct your questions or comments to Joseph Graziano at (732) 516-5560 or Ann McIntosh at (612) 677-5257.

Sincerely,

/s/ Grant Thornton LLP