



The Connecticut Society of Certified Public Accountants



LETTER OF COMMENT NO. 17

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Technical Director Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856
Via email

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The members of the Accounting and Reporting Standards and Not-for-Profit Committees of the Connecticut Society of Certified Public Accountants are pleased to submit their comments on the Proposed Statements of Financial Accounting Standards, Not-for-Profit Organizations: Mergers and Acquisitions and Not-for-Profit Organizations: Goodwill and Other Intangible Assets Acquired in a Merger or Acquisition.

The views expressed in this letter are those expressed by members of the Accounting and Reporting Standards and Not-for-Profit Committees. These views are not necessarily the view of the membership of the Connecticut Society of Certified Public Accountants.

We appreciate the opportunity to present our comments. Should there be any questions, please feel free to contact Bruce Blasnik, member of the Accounting and Reporting Standards Committee at 203-323-2400.

Very truly yours,

Bruce Blasnik, CPA
Connecticut Society of Certified Public Accountants
Accounting and Reporting Standards Committee Member

The committees applaud the Board's work on the Proposed Statements of Financial Accounting Standards, Not-for-Profit Organizations: Mergers and Acquisitions and Not-for-Profit Organizations: Goodwill and Other Intangible Assets Acquired in a Merger or Acquisition. While mergers and acquisitions are not normal activity for not-for-profit organizations, non-profit boards do need mechanisms to evaluate whether a combined organization would meet the organization's objectives. We see the primary objectives of not-for-profit organizations combinations as fulfilling mission and improving organizational processes. Consequently, we do generally favor a fair value approach to not-for-profit combinations, particularly with respect to tangible and financial assets.

We are less comfortable with valuing donor relationships and goodwill impairment measurement. Two primary concerns expressed are that a) placing a value on donor relationships can be akin to recognizing income from possible future contributions that otherwise don't meet the criteria for recognition under any other accounting principles and b) measuring goodwill impairment in the not-for-profit environment is too subjective to be accurately quantifiable and may result in distorted, rather than improved, comparability.

We have concerns with the basic premise presented in the exposure drafts: that business combinations between not-for-profit organizations are essentially the same as business combinations between for-profit entities, unless there are unique circumstances. Business combinations in the for-profit world are undertaken with the sole intention of increasing the financial return to owners. Not-for-profit organizations have no owners, and the returns generated by non-profit organizations can't be measured solely in financial terms. Any attempt to do so may be inappropriate and misleading. How does one place a "fair value" on healing the sick, housing the homeless, feeding the hungry, promoting the arts, or educating our children? While there are often financial considerations in not-for-profit business combinations there are also other, mission-based considerations which may be much more relevant than financial returns. Financially focused, return-on-investment criteria are therefore not a valid measure of value in the not-for-profit world. Furthermore, where there are financial benefits that result from the combination of two not-for-profit organizations, the beneficiaries of the transaction are not the "investors" (contributors or supporters). Because not-for-profit business combinations are very different from business combinations in the for-profit world, some accounting rules should not apply to both types of transactions.

We believe that:

- Assigning and recognizing a value on acquired donor relationships is the equivalent of recognizing contributions that don't meet the recognition criteria of SFAS 117 and such relationships should not be recognized as the result of a business combination.
- There are numerous circumstances where one can't measure goodwill impairment quantitatively in situations where the proposed standards require a quantitative measure. Furthermore, we believe that it may not be possible to develop meaningful qualitative standards for evaluating goodwill impairment, and that attempts to do so would negatively impact comparability rather than improving it.

Donor Lists

Consider the following example:

MOW delivers meals to senior citizens and handicapped individuals. Total revenue and support is \$1,000, consisting of \$500 of fee income, \$250 of government contracts, and \$250 of contributions. Despite the use of numerous

volunteers and significant cost cutting measures over the last 24 months, MOW still has annual expenses of \$1,050, consisting of program services of \$800, administrative costs of \$150, and fundraising expenses of \$100. Due to recurring losses, MOW has no choice but to shut its doors or merge with SSI, an organization who provides other complementary services to similar constituents. MOW's board agrees to merge with SSI in a transaction where SSI would be the surviving entity. As a result of the merger, administrative costs of \$100 will be cut from the combined entity.

At the time of the merger, MOW has equipment and accounts receivable with a fair value of \$150 and liabilities of \$150. SSI's controller performed a study and found that the average longevity of MOW's donors has been 12 years. A study of MOW's financial statements indicates that fundraising costs have averaged 40% of donor support. Applying a discount rate of 20%, SSI's controller determined that MOW's donor list has a fair value of \$566.

As a result of the merger, SSI records contribution income of \$566, which will be amortized on an accelerated basis over 12 years.

The recognition of the \$566 in the example above represents the recognition of net future donations that may or may not actually be realized and do not meet the recognition criteria under SFAS 117. Yet, simply due to the fact that SSI took over the operations of a struggling entity serving similar constituents, SSI now recognizes the income. This income significantly distorts SSI's statement of activities in the year of the merger, making them not comparable to similar organizations in other communities. Additionally, SSI's statement of activities will continue to be distorted by the recognition of amortization expense over the next 12 years.

We are concerned that in an effort to achieve consistency in accounting for mergers, the proposed standards result in a lack of consistency with other, more relevant, accounting principles. A second inconsistency is that the accounting for business combinations in the for-profit environment never results in the immediate recognition of income in the financial statements of the acquirer, why is recognizing phantom income preferable in not-for-profits?

A further consideration involves the classification of the \$566 of contribution income as either unrestricted or temporarily restricted. Under SFAS 117, pledges receivable that are due in more than 1 year represent an increase to temporarily restricted net assets. In the example above, the \$566 also represents income, most of which will be collected more than 1 year out. Does this therefore represent an increase to temporarily restricted net assets?

Goodwill

Consider the above example, but assume that contributions are \$100 instead of \$250, and that fundraising expenses are \$40 instead of \$100. The resulting annual loss is \$140. Further assume that MOW had drawn down on a line of credit to fund losses and that total liabilities are \$500, rather than \$150. Under the proposed standards, this would result in the recognition of goodwill of \$122, computed as follows:

Value of tangible and financial assets	\$ 150
Value of liabilities assumed	(500)
Value of donor list	<u>228</u>
Deficiency allocated to goodwill	<u>\$ (122)</u>

MOW represents a reporting unit that is not primarily supported by contributions and return on investments. Accordingly, under the proposed standards, the goodwill would have to be tested annually for impairment (beginning in the year after the acquisition) using a quantitative approach. Yet, once we strip out the contribution income and related fundraising costs (which we have already assigned a value to separate and apart from goodwill) the reporting unit shows a loss of \$100, after factoring in the cost savings of \$100. Even if SSI is able to get the MOW reporting unit to break-even with the \$60 of contributions factored in, the reporting unit would still be losing \$60 once the net contribution income is stripped out. It's not possible to support the goodwill using a quantitative approach, where a reporting unit requires the support of contributions to survive and the acquired donor relationships is valued separate and apart from goodwill. Even if the net contribution income were included in the cash flow analysis, you would get to break-even. There are no excess financial returns, and therefore goodwill would be impaired based solely on a quantitative financial analysis.

In the real world, these are the type of not-for-profit organizations business combinations that happen with the greatest frequency. Acquired reporting units may be able to operate at a break-even level once redundant overhead is eliminated and after consideration of continuing donor support. Excess liabilities are often cleaned up through a special fundraising campaign or by a few large donors making one-time contributions solely for the purpose of allowing a needed service to continue (these donors are not investors like in the for-profit environment, and they do not benefit personally from the transactions). Goodwill is not an asset that can be measured quantitatively, nor are qualitative measures reliable or quantifiable.

We do agree that tangible and financial assets and liabilities "acquired" in a business combination between two not-for-profit organizations should be initially recognized at fair value on the effective date of the business combination. Certainly, the excess of the fair value of the acquired tangible and financial assets over the cash paid and liabilities assumed represents a gain to the acquirer and should be recognized. We believe that this gain is better reflected as an "other change in net assets" below the line "excess of revenue and support over expenses", rather than as "revenue and support". This gain is, in essence, a contribution of capital. To recognize this gain as revenue and support would impair comparability from period-to-period and from organization-to-organization, and would thus be misleading.

There does, of course, also need to be a way to recognize the excess of cash paid and liabilities assumed over the fair value of the tangible and financial assets acquired. We agree this could represent an intangible asset similar to goodwill. However, for many reasons – the inability to measure fair value in future periods and thus objectively determine impairment, the fact that this intangible asset doesn't represent a resource to the organization, and the fact that the accounting for this asset is not consistent with the accounting for contributions – we don't believe that recognizing an intangible asset on the statement of financial position is the best accounting treatment. Rather, we favor recording this amount as an "other change in net assets" below the line "excess of revenue and support over expenses".

	<u>Example 1</u>	<u>Example 2</u>	
Fair value of tangible and financial assets acquired	150	150	
Fair value of liabilities assumed	-150	-500	
Donor list	<u>566</u>	<u>228</u>	
Contribution income (goodwill)	<u><u>566</u></u>	<u><u>-122</u></u>	
Revenue and support			
Fee income	500	500	500
Government contracts	250	250	250
Contributions	250	100	
	<u>1000</u>	<u>850</u>	<u>750</u>
Expenses			
Program	800	800	800
G&A	150	150	50
Fundraising	100	40	0
	<u>1050</u>	<u>990</u>	<u>850</u>
Decrease in net assets	<u><u>-50</u></u>	<u><u>-140</u></u>	<u><u>-100</u></u>