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LETTER OF COMMENT NO. 5

Financial Accounting Standards Board 401 Merritt 7 PO Box 5116 Norwalk, Connecticut 06856-5116

File reference: 1500-100

Exposure Draft - Not-for-Profit Organizations: Mergers and Acquisitions

Dear FASB:

I am writing to you as an individual donor with a strong interest is making not-for-profit financial statements useful. During my academic career, I have been involved in numerous research projects regarding colleges and universities, museums, environmental organizations and human service charities. Before I became a professor, I was director of finance for a large United Way member agency delivering social services of various types. I've also served on the board of directors of a local United Way as we made our decisions regarding allocations among local charities. I believe this background gives me a credible voice as a "user" of not-for-profit financial statements.

Before I begin answering the specific questions laid out in the Exposure Draft (ED), I would like to make some general comments. First, the accounting profession has long assumed that consolidated financial statements are more useful (meaningful) than separate statements (ARB51, Par. 1) and I generally have no problem with that assumption. Traditionally, accountants have looked at the entity from the perspective of its owners (parent company concept) and now we are moving toward a broader entity perspective that actually makes more sense from the perspective of not-for-profit (charitable) organizations. However, the empirical research on issues like the usefulness of purchased goodwill and intangibles has generally been related to whether investors find this information beneficial. For example, I just saw a study that reported an association between recently acquired goodwill and stock prices but not between older goodwill amounts and stock prices. With not-for-profit entities, there are no owners to derive personal financial gain from their investments. Accordingly, we really don't know whether financial statements that fully consolidate unrelated business activities with the not-forprofit activities will be more or less useful to resource providers. Personally, I want to see the not-for-profit activities at least segregated from unrelated business activities. This may be a matter of display that will be addressed later in another project but I would like to see a standard that avoids confusion as much as possible. In other words, I don't think expenses related to unrelated business activities should appear among the functional expenses and I would much prefer that the net revenues from such unrelated business activities be part of investment income.

The second issue concerns the usefulness of the intangibles that would result from adoption of the ED. As the Board itself acknowledges in the basis for conclusions, there doesn't seem to be much demand for the reporting of goodwill from the users of not-for-profit financial statements. I suggest that this same statement could be made with respect to all intangible assets. Lenders say they ignore intangibles in their analysis and the Department of Education specifically removes intangibles from the ratios used to determine financial viability of colleges and universities. As far as I'm aware, there is little information as to whether donors (small or large) would be influenced by the reporting of large amounts of goodwill and intangibles resulting from mergers and acquisitions. In my opinion, I think the information could very well be misleading rather than helpful because the recognition of intangible assets in accordance with the ED would inflate unrestricted net assets through the recognition of a larger contribution. Some financial statement users (including watchdog groups) belief that having excessive net assets is a bad thing - the organization should be using its resources to achieve its charitable mission. For example, one of the BBB's Wise Giving Alliance's (give.org) standards says that "the charity's unrestricted net assets available for use should not be more than three times the size of the past year's expenses or three times the size of the current year's budget, whichever is higher." (According to its implementation guide, the numbers come right off the audited financial statements with no mention of adjustments for unrestricted net assets tied up in illiquid assets.)

Having intangibles in the asset mix does not actually provide resources that can be "spent" in accomplishing the entity's charitable mission. In the long run, I hope that the Board will consider a more meaningful measure of available net assets, perhaps along the lines of the GASB categories which segregate the net assets absorbed by long-lived assets from the expendable net assets. For those donors who prefer to support not-for-profits that avoid excessive accumulations, this would be very helpful information. If such a change can be made, I certainly hope that the illiquid long-lived assets like goodwill and purchased intangibles will be excluded from any "expendable unrestricted net assets."

Question 1—Are the objectives in this proposed Statement appropriate for all mergers and acquisitions by a not-for-profit organization? If not, for which mergers or acquisitions are those objectives inappropriate, why are they inappropriate, and what alternative objectives do you suggest? What criteria do you suggest to distinguish those transactions to which a different financial reporting objective should apply?

With respect to "entity combinations" among not-for-profit entities (activities), I believe the objectives are appropriate. It is also appropriate for the acquisition of business activities that are intended to support the not-for-profit's mission (for example, a printing business intended to lower net costs of producing educational materials). With respect to certain gifts or other acquisitions of unrelated business activities, I'm not sure that the proposed rules will be an improvement over current standards. Currently, gifts are already measured at fair value and other acquisitions are made (presumably) at arms' length at what market participants believe to be fair value. While the Board chose to limit the scope of FAS124 (para. 31) to publicly-traded securities, it also chose "not to discourage not-for-profit organizations from using fair value to measure investments that are outside the scope of [FAS124]." As a consequence, a number of

not-for-profit entities currently carry many types of alternative investments in their investment portfolios at estimated fair value. Consolidation captures fair value at acquisition but does not (under current GAAP) recognize future changes in fair value. In this respect, the ED may be a step backwards for at least some not-for-profit entities.

Question 2—Is the definition of a merger or acquisition by a not-for-profit organization appropriate? If not, why and how would you modify or clarify the definition?

To me, paragraph 2 seems like a tautology, especially given the very broad definition of what constitutes a "business." In essence, the "definition" in the second sentence says that a merger or acquisition is the initial recognition of <u>any</u> activity. Neither not-for-profit (4-p) nor business activities (4-d) need be separate entities. That's a pretty mushy definition! The following change might help:

2. A not-for-profit organization shall apply this Statement in accounting for a merger or acquisition except when that merger or acquisition is between entities under common control. For purposes of this Statement, a merger or acquisition is any event that results in the initial recognition of another business or nonprofit entity activity (acquiree) in the financial statements of a not-for-profit organization. Thus, any event that requires an organization to consolidate a previously unconsolidated entity by initially recognizing its net assets is a merger or acquisition. Paragraphs 5 and 6 provide guidance to assist a not-for-profit organization in identifying a merger or acquisition.

I think it would also help to add a part "d" to paragraph 6 to describe the situation where a group of assets capable of being operated as a business or not-for-profit activity would <u>not</u> be treated as a merger or acquisition if the requirements of FAS144 para. 30 were met. In other words, an organization could have a policy of selling contributed business activities. It the planned sale will be completed within a year of the gift, it would make sense to exclude the entire transaction from treatment as a merger or acquisition. This would lower the costs of both to preparers and users (interpreting lengthy footnote disclosures related to both acquisition and disposition). Right now, the reader of the ED doesn't get a hint of this possibility without "reading between the lines" in the paragraph 34 discussion of "assets held for sale." The value of the contribution would be recognized at the fair value less cost to sell. Of course, I could be making an erroneous interpretation that the Board never intended. If so, let me suggest that an exception for entities that will sold promptly following acquisition is a fine idea!

Question 3—Is the retention of and reliance on the existing guidance on consolidation in SOP 94-3 and the health care Guide appropriate? If not, why and what alternative do you suggest?

I believe the Board should incorporate the rules currently in SOP 94-3 within the proposed standard to make it easier to understand. In other words, avoid the complications of having to refer to the SOP (for example, the definition of control in paragraph 4-i). I had never actually read the SOP and it took me awhile to find it. I think the ED, as written, generally captures the "spirit" of the SOP and a few more words here and there would make the SOP obsolete and unnecessary. For example, the Board might clarify that a noncontrolling interest in a business entity that entails significant influence should be accounted for under the equity method or at fair value if the securities are publicly traded. The last bit is a personal bias of mine

- I've never understood why the equity method is superior to market value just because significant influence exists! It seems to be just a vestige from the days before fair value accounting for investments.

Question 4—Are the definitions of a business and a nonprofit activity appropriate for distinguishing between a merger or acquisition subject to the provisions of this proposed Statement and a purchase of assets that would be accounted for in accordance with other generally accepted accounting principles (GAAP)? If not, why and how would you modify or clarify the definitions or the related guidance?

Absolutely not! The definition is so broad that it covers almost anything. The implementation guidance in A2-A7 does help but I won't be the only one asking for more guidance! After visiting with FASB staff in January, I realized that I needed to go back and look at the ED that may lead to a FAS141(R). In that ED, I see that the Board intends to nullify EITF 98-3 (which had made a valiant and useful attempt to identify which groups of assets constitute a business activity). Therefore, I guess it does no good to ask for that type of guidance – but I will anyway!

The stated objectives (para. 1) include the recognition of fair values of acquired activities (net assets) with some exceptions. The fair value of business entities received as donations can be measured and this measurement is the current basis for recognition in not-for-profit financial statements. Purchased business activities would presumably be at fair value or the transaction would not occur. In either case, the ED does not improve existing GAAP since fair value measurement already exists. So the issue that must be clarified is what "activities" comprise multiple financial statement elements that need to be separately recognized. For example, an acquisition of income-producing real estate (through gift or purchase) will be recognized at fair value whether we decide it is a "business activity" or not. If it comes with an attached loan, that element should probably be recognized as a separate element and not netted against the value associated with the land and buildings. Under the ED, goodwill might exist if purchased (but not if the real estate were a gift). In either case, the fair value of intangibles (relationships with tenants?) might be recognized but it is hard to see how one would distinguish that relationship from the valuation process used to determine the fair value of the real estate itself. It seems to me that we should be concentrating attention on sets of activities for which consolidation improves financial reporting.

I keep coming back to the problems with the "capable of' definition particularly for gifts of real estate. After all, renting and managing rental property is a "integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing economic benefits in the form of a return to investors." Processes presumably exist to collect rents, advertise vacancies, and provide janitorial and maintenance services (para. A2-b). Colleges and universities, foundations, museums, hospitals and other not-for-profit entities often hold real estate as investments in their endowment portfolios. The objective is not to operate rental property, per se. It is to generate an alternate source of investment income that will be used to accomplish the entity's not-for-profit objectives. Perhaps I'm over-reacting but it seems to me that consolidation would presumably entail the inclusion of such assets in the plant, property and

equipment category with rental income among revenues and the related utilities, maintenance, depreciation, etc., among expenses.

I can not think of any conceivable benefit such accounting would provide to me as a user of the financial statements! In fact, the operating expenses of such properties would distort the real relationship between program service revenues and related functional expenses. Clearly, real estate can be the program objective – there are millions of acres of land in this country that have been "saved" from development through the efforts of environmental organizations. Seeing the fair value of these assets on the balance sheet is potentially useful. The usefulness would be lessened considerably if real estate in the investment portfolio were to be commingled as a result of consolidation under the ED.

I would like to remind the Board of its earlier decision with respect to the insurance industry. In FAS60, the Board makes a distinction between real estate that is used in the business and real estate held for investment "depending on its predominant use." According to \$\\$52\$, depreciation and other real estate operating costs are classified as investment expenses or operating expenses depending on the balance sheet classification. This seems like the logical approach for income producing real estate held as an investment by a not-for-profit entity. As a donor, I am interested in the stewardship of resources — I do want to know if investments are being prudently and effectively managed. This will be more obvious if expenses are not commingled in the consolidation process. I realize that this is probably not the intended result of the ED but I fear it might be the practical result of the extremely broad "capable of being" definition of business activities.

Question 5—Do you believe control and those factors are appropriate for determining the acquirer in a merger or acquisition by a not-for-profit organization? If not, why and what additional factors or guidance should be considered?

The ED approach seems reasonable and workable.

Question 6—Is the requirement of this proposed Statement to recognize and measure the identifiable assets acquired and liabilities assumed at their acquisition date fair values appropriate and does it provide more complete and relevant financial information? If not, why and what alternative do you suggest?

I don't know of any proof that fair values of tangible assets will be useful to donors but they would certainly be helpful to creditors attempting to evaluate a not-for-profit entity's ability to repay a loan. The Board acknowledges the fact that lenders typically ignore goodwill (as discussed in B132-B138) and I think they also tend to ignore other intangible assets. Since there are no "owners" of not-for-profit organizations, there is certainly no reason to measure the full value of goodwill as will be done for for-profit entities under FAS141(R). Accordingly, the best advice for accounting for not-for-profit goodwill and intangibles is to "keep it simple."

My major concern is with the valuation of intangible assets. As I played with the numbers from the examples, I realized the following points with respect to the acquisition of (or merger with) a not-for-profit entity:

- 1. Goodwill can only be recognized if the acquirer "pays" for the acquiree through a transfer of assets or net assets. In this case, unrestricted net assets is unaffected until the goodwill is considered impaired.
- 2. If there is no transfer of assets by the acquirer, there is no goodwill. However, there is no limit placed on the total fair value recognized. Accordingly, the amount that could be recognized as a contribution is unlimited and will increase (unrestricted) net assets.

This second point is the big problem. Unlike the ED for FAS141(R), there is no test of reasonableness available for the recognition of fair values assigned to identifiable assets and liabilities. For a business combination under the FAS141(R) ED (as I understand it), the fair value of the acquired entity generally serves reasonable limit on the total fair values assigned. In other words, one would be hard pressed to argue for a very high value for patents and brand names in a bargain purchase situation (see para. 60 of that ED and related guidance). I believe that not-for-profit entities should NOT be recording fair values of intangibles unless there is (1) consideration — a transfer of assets by the acquirer or (2) the fair value of the acquiree as a whole can be reliably estimated.

The reliability of fair value measurements will always be an issue when markets for the assets do not exist. I'm comfortable with what I see in the FAS141(R) ED because the determination of fair value has an implicit reasonableness check. We will be looking the fair value of the consideration given by the acquirer in most cases. I suppose games could be played to increase estimated fair values of net assets to produce a gain attributable to the merger or acquisition. However, I imagine that auditors would first consider whether the fair values assigned to identifiable assets were indeed reasonable. This reasonableness limit or check is not available for not-for-profit mergers and acquisitions. That makes me very uncomfortable.

Question 7—Do you agree that identifiable donor-related intangible assets can be measured with sufficient reliability to be recognized separately from goodwill? If not, which identifiable donor-related intangible assets would not be measurable with sufficient reliability and why?

See comment above (Question 6) regarding the reliability of all the fair value measures needed to implement the ED. The remaining comments pertain to the specific issues of donor-relationships. I don't have a problem with assigning values to donor lists.

In FAS116, ¶97, the Board concluded "that because of social and moral sanctions promisors commonly feel bound by their unconditional promises, regardless of their legal status..." As a donor, I agree with this statement. However, in the ED the Board makes a giant leap and applies this same logic to the stream of FUTURE gifts that I might choose to make: "A written promise to contribute (for example, a completed contribution form), even if cancelable, represents a contractual right. Therefore, generally both the donor and customer contracts and the related relationships acquired in a merger or acquisition meet the contractual-legal criterion." (ED paragraph A26).

If I have completed a pledge form (contribution form), then I have committed myself to make a gift. However, I do not believe that I have thereby committed to making future gifts! I can think of no way that "social or moral sanctions" could cause me to "feel bound" to make

additional contributions. Future gifts will be based on my evaluation of whether the specific charity is continuing to work toward objectives I believe in and choose to support. Furthermore, I have every right to change my mind about what types of charities I would like to support! With respect to colleges and universities, I am most likely to give to the institutions I attended so those gifts might have an element of commitment. However, this is an exception to the general rule and if the nature of the educational institution were to change substantially because of a merger or acquisition, I would feel no moral obligation to continue making donations. Therefore, I do not believe that there is any donor-relationship intangible asset worth measuring!

In addition, FAS 116, Paragraph 96 quotes the second essential characteristic of an asset: "a particular entity can obtain the benefit and control others' access to it" (Concepts Statement 6, paragraphs 26). I can think of no situation where a nonprofit entity could control others' access to "the donor relationship" they have with me. In fact, if they sell my name to too many other charities or send me too many requests for donations, I will probably decide that they were not the type of organization I want to support at all.

Accordingly, I strongly urge the Board to remove the discussion of "donor relationship" from the list of possible intangible assets that could arise during a merger or acquisition. Customers are very different from donors and that's why donations are referred to (in the accounting literature) as nonreciprocal transactions. On the other hand, donor lists can be exchanged among nonprofit entities and sold (with some risks!) and therefore might be worth recognizing. However, donor relationships (unlike customer relationships) do NOT meet the contractual-legal criteria for intangibles and are clearly not separable from the mission-related future activities of the charity. In rare cases, past performance alone might bring in future gifts (bequests to one's alma mater) but past performance is rarely the only basis for a gift. Future donations generally require the expenditure of considerable resources to deliver desirable programs and to communicate the continuing success of those programs during future periods.

Question 8—Are the departures from recognition and measurement requirements in this proposed Statement appropriate accommodations to avoid the added difficulties and costs that would be incurred? If those accommodations are not appropriate, which exceptions would you add or eliminate and why?

The exceptions seem reasonable and consistent with what I see in the for-profit ED. The exceptions can always be eliminated in the future when and if fair value measurements are applied to those items.

Question 9—Are there other types of identifiable intangible assets that are prevalent in not-for-profit organizations that should be included as examples in Appendix A?

I can't think of any. Most mergers I've heard about involved struggling entities being absorbed by a larger not-for-profit organization. This situation would rarely give rise to intangibles or goodwill.

Question 10—Is the requirement of this proposed Statement that the acquirer limit its recognition of goodwill to the amount that is purchased (either through the transfer of

consideration or assumption of the acquiree's liabilities) appropriate? If not, why and what alternative do you suggest?

This was a good decision and makes perfect sense in the not-for-profit setting.

Question 11—Is the requirement of this proposed Statement that the acquirer recognize a contribution inherent in the merger or acquisition, measured as a residual, appropriate? If not, why and what alternative do you suggest?

There are lots of unsophisticated financials statement users. "Contributions" carries the connotation of liquid assets available for spending. In general, I like the presentation specified in paragraph 61 but would like some clarification for not-for-profits that report an intermediate operating measure. Please consider adding something like the following to the end of the paragraph:

While the provisions of FASB Statement No. 117, Financial Statements of Not-for-Profit Organizations, do not prescribe the items that shall be included within or outside an intermediate measure of operations or performance indicator, if one is presented, an entity shall present the merger or acquisition contribution(s) separately from the intermediate performance measure.

Question 12—Do you agree that a measurement period should be provided? Do you agree that a limit of one year following the acquisition date is appropriate? If not, why and what alternative do you suggest?

Seems practical and reasonable to me.

Question 13—Do you agree that the guidance provided for assessing whether any portion of the transaction price or any assets acquired and liabilities assumed are not part of the acquisition accounting is appropriate? If not, why and what alternative do you suggest?

I didn't have time to consider this issue in any great depth but it seems reasonable at least on the surface.

Question 14—Do you agree with the disclosure objectives? Do you agree with the specified minimum disclosure requirements? If not, why and what alternative do you suggest?

The disclosures are certainly lengthy (particularly with respect to public entities) and this is another reason to clarify more clearly what should be considered a merger or acquisition and what is merely the acquisition of assets. The cost will be quite prohibitive if every donation of a business activity must be treated as a merger/acquisition even if the acquirer intends to dispose of the business as quickly as possible.

Question 15—Do you agree that those disclosures for public entities would be useful to the users (donors, creditors, and other users) of a not-for-profit organization's financial statements? If not, why and what alternative do you suggest?

As a donor, I would probably ignore these disclosures. However, they might be useful to lenders and maybe to foundations and others evaluating financial stability.

However, please clarify the language of paragraph 4-q. The placement of commas makes it very unclear. As I read it, I couldn't quite decide if an entity would be classified as public only if it has to file financial statements with the SEC or if it provides financial statements for the purpose of issuing any class of securities in a public market. Are there two or three qualifying characteristics? In other words, is a museum that has conduit debt securities but no requirement for filing with SEC a public entity?

Question 16—How prevalent are noncontrolling ownership interests in a not-for-profit organization's consolidated financial statements? Is the guidance provided necessary and helpful? If not, why and what alternative do you suggest?

When I was "in practice" I never worked with a charity that reported a noncontrolling interest (NCI) and in my study of hundreds of not-for-profit financial statements, I recall none that mentioned any NCI although presumably such would exist even under current SOP 94-3 rules. Perhaps such transactions are common in the health care industry but they would appear to be rare for higher education and charities largely supported through contributions. Since the situation is presumably rare, it is likely to cause some confusion to unsophisticated readers when it does occur.

The complications of the financial statement display proposed in the ED are surely unnecessary. Footnote only disclosure along the lines of Exhibit 3 (in the illustration related to paragraph D24) should be sufficient for the "real accountants" who want to make sure the debits and the credits are nice and tidy. The NCI in consolidated net assets can be handled like a board-designation of unrestricted net assets that is involuntary (I know, I know, it isn't really the same!). My preferred treatment would be proportional consolidation in this situation because the NCI in unrestricted net assets is not available (ever) to the entity. As a donor and financial statement user, I have essentially no interest in the financial information needed by minority shareholders in an unrelated business entity. Likewise, these shareholders could derive no benefit that I can imagine from the consolidated financial statements of the not-for-profit parent. As discussed earlier, the resulting inflation of unrestricted net assets may cause charities some problems unless rating agencies get more sophisticated in analyzing "excessive accumulation" of net assets. Therefore, there will be a "cost" to be borne by those who use not-for-profit financial statements (regulators, donors, etc.) for any procedure other than proportional consolidation or maybe equity method display.

Question 17—Do you agree with the presentation requirements for noncontrolling ownership interests in a not-for-profit organization's consolidated financial statements? Do you agree with the accounting for noncontrolling ownership interests in a not-for-profit organization's consolidated financial statements and for the loss of control of subsidiaries? If not, why and what alternative do you suggest?

See answer to Question 16 – but I doubt the Board will accept proportional consolidation!

Question 18—What costs and benefits do you expect to incur if the requirements of the proposed Statement were issued as a final Statement? How could the Board further reduce the related costs of applying the requirements of the proposed Statement without significantly reducing the benefits?

With a few changes, I think that the preparer and users costs will turn out to be a minor annoyance for most charitable organizations. Mergers and acquisitions would be relatively rare and would generally not involve goodwill because there is no "cost" to the acquirer. (The health care industry might disagree but, in my opinion, they are essentially business activities and should therefore be treated much like a for-profit entity.) Here is a more concise list of my recommended changes.

Recommended Changes to ED

- 1. Groups of net assets that will be sold soon after acquisition (generally through donation) should not be consolidated if the provisions of paragraph 30 of FAS144 are met. It would also help to clarify the groups of assets that are "business activities" but just this addition would help.
- 2. Remove donor-relationship from the list of potential intangible assets to be identified and measured.
- 3. For acquisitions/mergers of not-for-profit entities (activities), limit the recognition of intangible assets to situations where the fair value of the acquired entity as a whole can be reliably determined. If there is no market for similar entities, fair values should be assigned only to identifiable assets for which FAS157 Level 1 or Level 2 inputs are available.

I am available to discuss or clarify any of these points if the FASB board or staff members feel that would be helpful. In general, the Board has made a nice effort to accommodate the special concerns of not-for-profit entities. I appreciate the Board's effort and hope my comments will be perceived as helpful.

Sincerely,

Teresa P. Gordon

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