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Criteria for Nonprofit Merger Treatment

Dear FASB:

The Board has requested additional comments regarding potential criteria for distinguishing a nonprofit merger from a nonprofit acquisition. As stated in my original letter, 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.

As I understand it, the proposed definitions include the following:

- A merger is a combination of nonprofit organizations that creates a new nonprofit
 organization that is not controlled by any of the combining entities. It occurs when the
 governing bodies of two or more not-for-profit organizations cede control of those
 organizations to create a new organization.
- In an acquisition, one organization obtains control over the net assets of another organization, business or nonprofit activity by purchase, gift or otherwise.
- Control is the direct or indirect ability to determine the direction of management and policies through ownership, contract, or otherwise.

Question 1: Is the definition of a merger appropriate for distinguishing mergers from acquisitions by not-for-profit organizations? If not, why?

I believe the proposed definitions provide a reasonable level of guidance. This guidance is clearly principle-based rather than rule-based. Supplemental guidance could be helpful, but it then quickly becomes rule-based as preparers request even more specific or detailed guidance.

Question 2: Would the definition of a merger, together with the definition of control, be workable in practice? That is, can it be applied in practice with a reasonable degree of consistency, particularly in distinguishing a merger from the transactions noted in paragraph 6(a) and 6(b)? If not, why, and how might it be improved?

In the definition of a merger, I think it would help to insert the word "permanently" before "cede control." That would make it pretty clear that the rules do not apply to joint ventures. Logically, any opt-out provisions would also move the combination from the "merger" definition. I don't think a donation of a nonprofit or a business organization to another nonprofit could logically be considered a merger under the definition as it stands (with or without the addition of "permanently.") In this case, the recipient entity retains control of both its own operations and obtains control of the donated operations. Control is ceded only by the contributor.

It might also help if the definition or standard clearly limited merger accounting to situations that do not have noncontrolling interests in the new organization.

Question 3: Do the definitions of a merger and control, taken together, make it sufficiently clear that transferring an integrated set of net assets to a newly created joint venture in which the transferor retains shared control is not the equivalent of ceding control? If not, how might the Board clarify the definitions or make it clear that the creation of a joint venture is beyond the scope of the proposal?

The Board needs to make it clear that the control that is given up is permanent in nature. That could be done as suggested above. If not, then a bit of supplemental guidance would be warranted, perhaps a few examples that demonstrate why a joint venture is not a merger, why a donation by one party to another is not a merger, and why an opt-out provision means that control was not ceded after all.

However, I do not agree with the specific way the Paragraph 10a example seems to be going. To me, ceding control happens when neither party has complete control over the activities of the new entity. Each party can retain influence but they can no longer act alone to determine the "direction of management and policies." In the merger of which I am most familiar, two rather equal-sized organizations merged and their net assets were transferred to a corporation with a new name. As I recall, former board members of both predecessor entities became board members of the new entity. One reason for the merger was to save administrative costs and gain the expertise of the executive director of one of the predecessors. In my mind, this was effectively a merger under your definition even though the new board retained some measure of "shared control in the combined entity." If you go too far down this road, the fact that only one of the two executive directors gets to head the new entity could cause someone to object to accounting for the transaction as

a merger because the ceding of control didn't go to parties previously unrelated to either predecessor.

Question 4: Does the definition of a merger require any additional criteria or guidance to address the concern noted in paragraph 10? That is, in general, will the ceding of control be discernable in practice from the surrounding facts and circumstances, despite the possibility that some entities may attempt to structure the new organization's Board composition, senior management, or charter to disguise circumstances in which one of the governing bodies retains control over the newly created organization?

I think the Board may be wasting time worrying over unlikely and relatively unimportant possibilities. The difference between merger vs. acquisition accounting will be the write-up of net assets including recognition of intangibles such as goodwill. In my previous comment letters, I've already noted that goodwill is pretty meaningless in the nonprofit world – at best, donors ignore the information, regulators remove the assets from ratios, and government agencies refuse to reimburse any impairment recognized. In my experience, government contractors never considered depreciation on donated assets as a reimbursable cost either. So, who cares if the occasional "acquisition" is recognized as a "merger?" I admit that this view is premised on my experience with "real charities" rather than the large fee-for-service nonprofits in health care and the like. In those cases, maybe it makes a difference but I still think the proposed guidance should be left as general principles.

Question 5: If one or more parties to a potential combination retains an opt-out clause, would that alone be sufficient evidence to determine that that party has not ceded control? Some respondents asked the Board to consider whether retention of so-called opt-out clauses by the parties to a combination would indicate that a merger or acquisition had not occurred. The staff has been told that such contingent provisions sometimes are included in acquisitions of physician practices by not-for-profit organizations. However, presumably, such provisions could occur in mergers or acquisitions of other private practices, including acquisitions by business entities. The staff thinks that the specific terms of each contractual arrangement need to be assessed to determine whether the definition of a merger or acquisition has been met and would not expect a unique interpretation for mergers or acquisitions by not-for-profit organizations.

I know I haven't thoroughly absorbed FAS141R but, last I heard, pooling of interest accounting was only permissible under IFRS and US GAAP requires acquisition accounting for combinations of business entities. In other words, the proposed definition of a merger is to apply ONLY to combinations of nonprofit entities. If this is indeed the intention, the merger of a for-profit physicians' practice with a nonprofit hospital could not be considered a merger in the first place. I definitely feel that the inclusion of a for-profit entity in any combination of entities should trigger acquisition accounting.

To me, there is no question that an opt-out provision is an indication that control has not been ceded. If such provisions are part combination agreements of nonprofit entities, then auditors are going to have to read through the specific terms of the contractual arrangements and look for any type of opt-out provision that could result in continued control over the net assets and operations of any party to a combination. Isn't that what auditors are supposed to do anyway?

Apparently, the Board is trying to come up with single definitions (e.g., control, acquisition, and merger) that will work for both for-profit and not-for-profit combinations. This

may not be feasible. In FAS141R, I notice that "merger" does not seem to be defined. Presumably, mergers need only be part of the definitions pertinent to not-for-profit accounting. Right now, the standards clearly say that a merger always receives acquisition accounting when for-profit business entities combine. To save confusion, we may need a different term for a merger of nonprofits: a fusion of nonprofits? a blend of nonprofits? a wedding of nonprofits? While I'm out of good ideas, a new term would make it easier to discuss the "non-acquisition" treatment permissible in some situations when not-for-profit entities combine.

I am available to discuss or clarify any of these points if the FASB board or staff members feel that would be helpful.

Sincerely,

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