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



LETTER OF COMMENT NO.



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Exposure Draft - Not-for-Profit Organizations: Goodwill and Other Intangible Assets Acquired

in a Merger or Acquisition

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.

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?

No. The accounting requirements for intangible assets are not sufficiently understandable and will be costly to apply. The ED proposes that the usual impairment test of FAS142 be applied. There are several problems with this approach. (1) The list of triggering events (FAS144, para. 8) does not seem particularly helpful for the evaluation of not-for-profit intangibles. Perhaps the implementation guidance could be expanded to provide more helpful examples - if the Board doesn't like my proposed solution. (2) As best I can tell, FAS157 removes footnote 12 to paragraph 17 in FAS142 which referred to the measurement guidance in paragraphs 23-25 (which FAS157 did amend). So now there is no specific guidance on how the fair value of intangibles should be determined. Other than donor lists (limited life item), I can't think of too many not-for-profit intangibles with unlimited life that would have a market value. An exception might be "WWF" as a brand forbidden to the wrestling folks by World Wildlife Federation. However, that was probably an internally developed and unrecognized intangible asset.

In other words, not-for-profit organizations are probably going to need to do expected present value computations (FAS157) using Level 3 inputs to determine whether an acquired intangible asset has been impaired. If this was "too much" to expect for the goodwill impairment test, it is too complicated for intangible assets too!

If the Board takes steps to alleviate my concerns regarding the lack of any type of "reasonableness test" on the fair values assigned to not-for-profit entities upon merger/acquisition (see my letter on 1500-100 ED), intangible assets will be relatively rare. They would be recognized only when the acquirer transfers assets as part of the merger/acquisition unless the fair value of the not-for-profit acquiree can be reliably measured. Intangible assets have little or no utility in the evaluation of not-for-profit organizations by lenders and donors (the primary user groups for financial information). I therefore argue that it makes no sense to require costly annual impairment tests that would probably be necessary if the ED becomes GAAP.

My recommendation: Intangibles assigned to reporting groups comprised of not-for-profit activities should use a qualitative evaluation similar to what is proposed for the impairment tests of not-for-profit 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?

Yes – the qualitative impairment test is a great idea. However, I think it should be more widely available and not restricted to "units that are primarily supported by contributions and returns on investments." In trying to come up with an alternate approach, the wording gets pretty tricky (my effort follows). Many not-for-profit activities could not be provided without contributions even when program service fees cover more than half of the cost to deliver the services. For example, many social services use sliding fee scales based on the client's household income -- some pay more, some pay less but generally even the higher income people do not pay MORE than the market value of the service. If they had to pay more than market value for nursing home, child care, or adoption services, the client/customer would not stay with the not-for-profit provider. The not-for-profit provider would have fewer "full pay" customers and would then require even more contributions. This would be a very poor strategy. Because of the subsidized services provided, I believe not-for-profit activities of this type are still "not-for-profit" rather than "business" activities.

Using the ED as written, these types of not-for-profit activities would be precluded from the use of the qualitative method for assessing goodwill impairment. Nevertheless, the activity would operate at a deficit without contributions (and possibly investment income). Therefore, the goodwill would probably be immediately written off – but only after a lot of effort to document the impairment.

Educational activities at colleges and universities are also not-for-profit activities even though investment income and contributions are not more than half of total revenues. According

to a recent paper (Engstrom 2003), private colleges and universities received 43% of revenues from tuition and fees in 1996-97 and only 5% from investment income and 9% from private gifts and grants. Accordingly, under the ED as written, the average college or university will be using the fair-value-based evaluation method for goodwill. I'm assuming that the institution (apart from auxiliary services) is deemed to be a single reporting unit for several reasons. First, tuition rates are often the same for all majors which results in cross-subsidization between colleges. Second, a large amount of operating income is from federal and other grants that are essentially conducted for the advancement of knowledge rather than economic gain. In fact, many grants primarily cover direct costs and provide only small amounts toward institutional overhead. Third, cost accounting is practically non-existent. Many colleges and universities treat "facilities" as a reporting unit and these costs are not assigned to the individual colleges. In this environment, goodwill impairment tests will be quite burdensome.

Let me provide an example based on an actual acquisition I heard about from a colleague. A major university acquired a not-for-profit research institute and the acquisition included the payment of cash to the previous host institution. The acquisition was not motivated by the desire to earn a larger profit or to increase cash flows since the grants and contracts that came with the institute would not recover the entire cost of conducting the research. The associated future cash inflows would be more than offset by future cash outflows. Nevertheless, the acquirer believed that the acquiree would bring additional prestige to the university as well as talented scientists that could help attract future students. In other words, there was substantial goodwill and/or other intangible benefits associated with the acquisition. In this case, I believe a qualitative impairment test would be appropriate. Triggering events might include the loss of one or more of the scientists, the loss of the administrator (a whiz at securing contracts), or the substantial decline in total annual research grants secured. A fair-value-based evaluation could be performed but the cost could be substantial and the resulting impairment of goodwill would probably occur in the same period whether the qualitative or the fair-value-based test were used.

The Board might choose to tinker with the criteria for the qualitative vs. fair-value-based impairment tests – something like the following:

Paragraph 4

- c. The *fair-value-based evaluation* is an impairment evaluation method that identifies and analyzes goodwill for impairment based on a two-step quantitative analysis. A not-for-profit organization uses that method to evaluate goodwill for impairment and to measure the amount of a goodwill impairment loss to be recognized (if any) for a reporting unit that is primarily supported by resources that are intended to recover substantially all of the costs incurred to provide the goods or services, other than contributions and returns on investments. Statement 142 requires the application of that impairment evaluation for any business entity.
- g. The *qualitative evaluation* is an impairment evaluation method that identifies and analyzes goodwill for impairment based on a qualitative analysis. A not-for-profit organization uses that method to evaluate goodwill for a reporting unit that is a not-for-profit activity as defined in {M&A ED} paragraph 4(d). Support is primarily provided by contributions and returns on investments and subsidized program service fees that do not substantially cover the cost of the goods and services provided.

After a lot of thought, however, I've decided that the best approach to "fixing" the ED's "primarily supported by contributions and returns on investments" criteria would be simplification: Let not-for-profit activities use the qualitative method. All business activities (even related business activities like a museum gift shop) would use the usual fair value method.

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?

See my response to Question 2. Reporting units may be not-for-profit activities even if program service fees comprise more than half of the total revenues. I suggest avoiding the complications of any "bright-line" (or even blurry line) distinctions by permitting the not-for-profit entity to determine which reporting units are not-for-profit activities and which reporting units are business-type activities. Use the qualitative method (ED paragraph 4g) for all not-for-profit units and the fair-value-based-evaluation (ED paragraph 4c) for all business-type reporting units.

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?

The guidance related to the qualitative evaluation seems practical and considerably less costly for preparers and auditors. Since I'm not convinced of the usefulness of goodwill and intangibles to lenders and donors, I can't see that the simpler method would be significantly less useful than the fair-value-based method. See the research institute example in my comments on Question 2 above.

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?

The triggering event guidance seems appropriate. If the Board likes my suggestion for adding a comparable qualitative method for the evaluation of intangibles with an indefinite life, it should add equivalent triggering event guidance for other intangibles.

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?

When I read the ED, I was under the impression that the triggering events could be designated in such a way that a particular event would reduce goodwill by a specified amount or percentage. In other words, the triggering event mechanism does not have to be an "all or nothing" approach. If the goodwill is related to five Nobel-prize-winning scientists, 20% of goodwill could be written off upon the termination of any one of the scientists. If you really

meant that any triggering event would automatically eliminate goodwill, that doesn't seem quite as reasonable to me. However, my objection would be mild given my views on the unimportance of goodwill to creditors and donors!

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?

If the Board accepts my proposed simplification (i.e., qualitative method for not-for-profit units and quantitative method for business-type units), the existing guidance would need modification. The heading for the section that begins in paragraph 22 would be "Determining the Nature of the Reporting Unit's Activities." I would expect that such guidance would delineate the extremes of the continuum between for-profit and not-for-profit activities. For example, most not-for-profit hospitals are business-type activities because the patients and third-party payers negotiate for market-based prices for care. Even here exceptions could exist for hospitals that provide significant amounts of purely charitable care (more than bad debts!). Most nursing homes and child care centers would probably be at the business-type end of the spectrum. A soup kitchen that feeds the needy would be at the other extreme — a purely not-for-profit activity. Most environmental organizations and public radio would probably be near that end as well. Major colleges and universities would tend to be in the middle with many smaller tuition dependent institutions being much closer to business-type activities. I just don't see any way for the Board to come up with a definition that will satisfy everyone! Leave the judgment to the not-for-profit entity!

With these changes to paragraph 22-23, similar modifications would be needed to paragraphs 24-32. However, the general approach of that section would be the same.

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?

I actually expect the preparer costs to be quite low but only because there will be relatively few situations where goodwill is recognized when a not-for-profit organization acquires another entity. This is based on what I know about higher education and "charitable" organizations other than health care. The benefits are always harder to identify and measure. In this case, the benefits come from the recognition of many assets at fair value (land, buildings, liabilities, etc.) rather than the recognition of goodwill and intangible assets. Since this ED is about "what to do with intangibles after recognition," the benefits are less clear. As I've argued above, lenders tend to disregard intangibles since they are generally illiquid and therefore do little to improve a not-for-profit entity's perceived credit-worthiness. I think I can recall less than a dozen cases where I might have seen goodwill or other intangibles reported on a not-for-profit balance sheet. When I did see it, I briefly wondered how in the world did it happen and went on my way. My propensity to donate is far more related to what I see on the statement of activities. I would not be happy to realize that a substantial portion of reported program services

were comprised of impairment losses related to goodwill and intangibles. The way the ED is written, I would have to be paying close attention to the footnotes to discover such impairments – there seems to be no requirement that impairment be reported separately on the statement of activities. This is clearly a COST to me as a user. I would not consider an impairment loss as something that provided the kind of not-for-profit goods or services I would choose to support!

Therefore, I must conclude that the costs to users and preparers are quite high and probably outweigh the benefits. The ratio would improve if the standard is simplified along the lines of my suggestions. I have summarized my recommendations below.

Recommended Changes to ED

- 1. For intangibles assigned to not-for-profit units, permit the use of a qualitative impairment test for intangibles other than goodwill.
- 2. Permit wider use of the qualitative impairment test for goodwill by eliminating the "primarily supported by contributions and investments" criteria. I believe the FASB should let each not-for-profit entity identify whether its reporting units are primarily not-for-profit activities or primarily business-type activities. Guidance would be provided primarily by examples on each end of the continuum that Bob Anthony described in the 1978 FASB research report. I also recommend Falk (1992) for a nice discussion of the different types of not-for-profit entities.

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. My comments are intended to be constructive and helpful.

Sincerely,

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References

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