MEMORANDUM

Financial Accounting Standards Board

To: Board Members

From: Not-for-Profit Team
(Budak, 847-891-6081;
Maffei, ext. 273)

Subject: Minutes of the December 18, 2002 Board Meeting

Date: January 2, 2003

cc: NFP Combinations Team, Bielstein, Smith, Leisenring, Swift, Polley, Gabriele, Sutay, Thompson, Schermann (GASB), FASB Intranet

Topic: Combinations of Not-for-Profit Organizations: Scope and Goodwill

Basis for Discussion: Staff Memorandums dated December 10 and 12, 2002

Length of Discussion: **Starting Time**: 11:00 a.m. **Concluding Time:** 12:15 p.m.

Attendance:

Board members present:	Herz, Crooch, Foster, Schieneman, Schipper, Trott, and Wulff
Staff in charge of topic:	Budak
Other staff at Board table:	Bielstein and Maffei

Matters Discussed, Decisions Reached, and Follow-Up Action:

The Board discussed several issues related to the scope of the proposed Statement and the accounting for goodwill.

With respect to the scope of the proposed Statement, the Board decided that:

- The scope of the proposed Statement should *include* combinations in which no combining entity dominates the process of selecting a voting majority of the combined entity's governing board (transactions which are sometimes referred to as mergers of equals).

- The following transactions should be *excluded* from the scope of the proposed Statement:
  - A transaction in which control is obtained through means other than an acquisition by purchase or gift of net assets or equity interests
  - The formation of a joint venture
  - The acquisition of noncontrolling interests
  - A transfer of net assets or exchange of equity interests between entities under common control.
- Combinations of not-for-profit organizations should be distinguished from acquisitions of assets subject to certain liabilities based on whether the transferred set of processes and assets represents an *activity*. The Board decided to define an activity as an integrated set of processes conducted and assets managed for the purpose of providing goods and services to beneficiaries, customers, or members that fulfill the purpose or mission for which an organization exists. An activity consists of (a) inputs, (b) processes applied to those inputs, and (c) resulting outputs that are used to provide goods and services to beneficiaries, customers, or members. For a transferred set of processes and assets to be an activity, it must contain all of the inputs and processes necessary for it to continue to conduct normal operations after the transferred set is separated from the transferor.
- The project should provide general guidance to describe the accounting for an acquisition of assets subject to certain liabilities.
- Although the definition of a combination transaction is based on a notion of *control*, control would not be defined in the standards section of the proposed Statement. The Board decided, however, that the basis for conclusions would provide existing GAAP definitions of control.
- The proposed Statement would include name and size of the parties to the combination as possible indicators for identifying the acquiring organization but will not require that those indicators be considered in all combinations.

With respect to accounting for the impairment of goodwill, the Board directed the staff to analyze the merits of the following two alternatives:

- If the acquired not-for-profit organization (and the reporting unit into which it is integrated) is identified as primarily supported by fees and charges to third parties for goods and services provided by the not-for-profit organization, goodwill of that reporting unit would be tested for impairment using the fair value method described in FASB Statement No. 142, *Accounting for Goodwill and Certain Intangible Assets*. If the acquired organization (and the reporting unit into which it is integrated) is supported primarily by contributions, goodwill would be tested for impairment using a trigger-based approach. Under that approach, goodwill would be written off in its entirety when certain triggering events occur.

- If the fair value of the acquired entity and the reporting unit into which that acquired entity is integrated can be measured with sufficient reliability, goodwill would be tested for impairment under Statement 142 (that is, it would be tested for impairment using the fair value approach). Organizations that are unable to reliably determine the fair value of the acquired entity would test goodwill for impairment using the trigger-based approach (that is, write off goodwill in its entirety when certain triggering events occur).

Under either alternative, the Board acknowledged that if an organization is able to apply the fair value approach to testing goodwill for impairment required by Statement 142, it also should be able to determine the acquired entity's fair value at the date of acquisition. Thus, the Board plans to reconsider its earlier decision that goodwill not be recognized in an acquisition by gift.

Scope

Ms. Budak explained that in defining the scope of the project, the staff began by looking at the scope and definition of a combination that is used in FASB Statement No. 141, *Business Combinations*, with the assumption that the scope of this project should follow that of Statement 141 unless significant differences exist for not-for-profit organizations that would justify a modification to the scope or definition of Statement 141.

Issue A1- Which transactions should be explicitly included in or excluded from the scope of the proposed Statement?

She said that the staff recommended one change from the scope of Statement 141, which is to exclude the acquisition of noncontrolling interests from the scope of this project. She stated that the Board decided to provide standards for the acquisition of noncontrolling interests in the Purchase Method Procedures project. The Board agreed with the staff recommendation.

Issue A2- How should the Board distinguish a combination from an acquisition of assets subject to certain liabilities?

Ms. Budak stated that the staff recommends that the Board distinguish a combination from an acquisition of assets subject to certain liabilities by substituting the phrase "constitutes an activity," for the phrase "constitutes a business" in the description of a business combination in Statement 141. Further, she stated that the staff proposes that an activity be described by modifying the description of a "business" in EITF Issue No. 98-3, "Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business," for the characteristics of a not-for-profit organization, as is shown on page 12 of the memo for this meeting. Statement 141 uses the description of a business from Issue 98-3 to distinguish a business combination from an acquisition of assets subject to certain liabilities. The staff also recommends that paragraph 6 of Issue 98-3 be included in Appendix A (Implementation Guidance) of the proposed Statement. The Board agreed with the staff recommendation, with Ms. Shipper and Mr. Wulff making the suggestions noted below.

Ms. Shipper questioned why the staff had chosen the term "activity." Ms. Budak answered that that term had been chosen because (a) FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations,* uses the term "statement of activities" to describe the financial statement that includes the revenues, expenses, gains, losses, and reclassifications of the not-for-profit organization, and (b) Statement 117 describes two broad functional classifications of expenses—programs services, which are activities that result in goods and services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the organization exists, and supporting activities, which are all the activities of a not-for-profit organization other than program services.

Ms. Schipper expressed concern that the term "activity" was being used in two ways: (1) to describe the functional operations of the organization (that is, program services and supporting activities) and (2) to represent a collection of assets and liabilities analogous to a business. She posited that the ambiguous usage might be a source of confusion, but noted that currently she could not offer a preferable alternative.

Mr. Wulff stated that in order to be consistent with Issue 98-3 and the differences-based approach of this project, the definition of activity should include the notion of "self-sustaining," modified to apply to not-for-profit organizations. Ms. Budak said that she disagreed because many activities of a not-for-profit organization are not self-sustaining; they cannot generate revenues equal to or greater than their expenses. She gave the example of a voluntary health and welfare organization with three activities: a family counseling service, a daycare center, and a teen pregnancy prevention service. Each of the three activities charges fees on an ability-to-pay basis, but no activity individually generates revenues great enough to cover the expenses of that activity. The voluntary health and welfare organization is self-sustaining as a whole because it receives contribution revenues. Ms. Budak said that, in her opinion, the purchase of the assets and workforce of the family counseling service from the voluntary health and welfare organization should be within the scope of the project even though the counseling service is not self-sustaining. The discussion continued with several Board members participating until Mr. Wulff said that he generally agreed with the staff's recommendation to distinguish a combination from a purchase of assets subject to certain liabilities using the term "activity" and a modification of the description of a business in Issue 98-3, but that he would continue his discussion of the self-sustaining notion with the staff.

Issue A3- <u>Should the proposed Statement describe in general terms how to account for an acquisition of assets subject to certain liabilities?</u>

Ms. Budak said that the staff recommends that the Board describe in general terms how to account for an acquisition of assets subject to certain liabilities that is not an activity (that is, an acquisition that is outside the scope of the proposed Statement). She said that Statement 141 includes a section entitled "accounting for asset acquisitions—general concepts" and FASB Statement No. 147 *Acquisitions of Certain Financial Institutions—an amendment of FASB Statements No. 72 and 144 and FASB Interpretation No. 9,* provides guidance on how to account for the acquisition of a less-than-whole financial institution. Ms. Bielstein pointed out that, in part, the reason for including that guidance was to clarify situations in which it is appropriate to recognize goodwill. The Board agreed that the proposed Statement should include general guidance about how to account for an acquisition of assets subject to certain liabilities similar to the example that appears on page 13 of the memo for this meeting.

Issue A4- <u>If the definition of a combination includes a change in control, should the Board define control in the proposed Statement, and if so, how should it be defined?</u>

At the Tech Plan meeting of October 1, 2002, the Board asked to revisit its decision made at the Board meeting of September 13, 2000 to define control used in the proposed Statement using the definition of control in the February 1999 FASB Exposure Draft, *Consolidated Financial Statements: Purpose and Policy.*

Ms. Budak stated that the staff recommends excluding a definition of control from the standards section of the proposed Statement, but providing existing GAAP definitions of control in the basis for conclusions, as was done in FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*. Mr. Foster stated that he prefers to have a definition of control, but recognizes that it might not be possible to do so in a cost-beneficial manner. Mr. Herz noted that developing a definition of control might be beyond the scope of this project. The Board agreed with the staff recommendation.

Issue A5- Should the proposed Statement include name and size as possible indicators for identifying the acquiring organization, as is done in paragraph 17 of Statement 141?

Ms. Budak explained that the staff could not identify circumstances unique to not-for-profit organizations that would justify a departure from the standards in Statement 141. Thus, the staff recommends that the Board include in the Implementation Guidance sentences similar to Statement 141 regarding name and size. The Board agreed that name and size should not appear as indicators to be considered in all cases but will be shown as general observations, as was done in paragraph 17 of Statement 141.

Goodwill

Issue B1- If goodwill is recognized in a combination in which the acquiring entity is a not-for-profit organization, how should it be accounted for subsequent to its initial recognition?

At the November 20, 2002 meeting, the Board asked the staff to report to the Board on the operationality of a trigger-based write-off of goodwill. The staff contacted the members of the not-for-profit working group and asked for their help.

Ms. Budak stated that during two conference calls with working group members, almost all of the members suggested that the Board had abandoned a Statement 142-type approach too easily. Some working group members suggested a Statement 142 impairment test that is conducted upon the occurrence of trigger events, rather than annually. Several other members suggested a two-path test, in which certain not-for-profit organizations, which the working group members identified as business-type or as exchange revenue supported, would perform impairment tests as described in Statement 142. Other organizations, which are supported primarily by contributions, would write off goodwill upon the occurrence of trigger events.

Ms. Budak said that after considering the input from the working group members, the staff would like to change its recommendation from that made at the November 20, 2002 meeting. The staff recommends that:

1. At the date of acquisition, the assets and liabilities assumed in the combination, including goodwill, should be assigned to reporting units as described in Statement 142.

2. If a reporting unit is primarily supported by revenue it generates by providing goods and services to customers or other beneficiaries (that is, exchange transactions), goodwill of that reporting unit should be tested for impairment using the standards in paragraphs 19–22 of Statement 142.

3. If a reporting unit is primarily supported by contribution revenues or unrestricted endowment income, goodwill of that reporting unit would be written off upon the occurrence of certain trigger events. Those trigger events would be similar to those in paragraph X2 of the draft standard distributed to the working group members and should be related to the reasons for entering into the transaction, which also must be disclosed.

Some Board members were concerned that a Statement 142-type test might be problematic even if a not-for-profit reporting unit was supported by exchange transactions. Mr. Trott asked whether an estimate of fair value using present value techniques would use the actual revenues generated by the reporting unit or the revenues that might be possible if the reporting unit was operated as a for-profit business. Ms. Budak said that since the present value technique is supposed to estimate fair value rather than entity-specific value, present value techniques should encompass a market expectation of revenues, which would mean that revenue estimates for operation as a for-profit business would have to be used if a potential purchaser in the marketplace was a business enterprise. Ms. Shipper suggested that the Board use a description that it has used in other projects—"the most favorable market to which the entity has access."

Mr. Wulff suggested that the goodwill recognition question would be resolved if the definition of activity included the notion of self-sustaining. He said that if goodwill was recognized only for (1) self-sustaining activities and (2) activities that had a "business analog," a Statement 142 impairment test could be applied. He said that a business analog was a for-profit activity comparable to the not-for-profit activity. For example, a not-for-profit hospital has a business analog in a for-profit hospital. On the other hand, a soup kitchen does not have a business analog, so no goodwill would be recognized at acquisition unless the soup kitchen was self-sustaining.

Ms. Bielstein asked whether a not-for-profit entity that supports itself through contributions is self-sustaining. Mr. Herz said that the customers of a not-for-profit organization are its contributors, and, thus, a not-for-profit organization would be self-sustaining if it could generate contributions sufficient to support its programs. Ms. Shipper said that she would not object to including "self-sustaining" in the definition of an activity if self-sustaining were described in a sufficiently broad manner that would include a not-for-profit organization's proven capacity to generate contributions; however, she thought that the Board members would have differing ideas of what self-sustaining should mean.

Ms. Bielstein suggested an alternative approach for recognition of goodwill that is based on the notion of whether a reliable estimate for the entity's fair value can be determined. She suggested that organizations that are able to reliably estimate the fair value of the acquired entity and the reporting unit to which that acquired entity was integrated would account for goodwill under Statement 142 (that is, test goodwill for impairment using the fair value approach). Organizations that are unable to reliably determine the fair value of the acquired entity would test goodwill for impairment using the trigger-based approach (that is, write off goodwill in its entirety when certain triggering events occur).

Mr. Foster expressed concern that the reliability notion would allow entities to select the most preferable accounting treatment regardless of whether that treatment was the most appropriate. Ms. Bielstein suggested that to limit choices the staff could identify indicators for whether reliable estimates for an entity's fair value can be determined.

The Board instructed the staff to investigate further two approaches to recognition of goodwill as described on page 3 of these minutes. They asked that the staff contact the working group for their opinions. They also instructed the staff to ask the working group members why it was possible for "business-type" not-for-profit organizations to apply Statement 142 but not possible for an organization to determine the acquired entity's fair value at the date of acquisition by gift.

Issue B2- <u>In a nonreciprocal combination, is the excess of the fair value of the liabilities assumed over the fair value of the assets acquired goodwill?</u>

Mr. Foster asked Ms. Bielstein whether goodwill would be recognized in her suggested approach if at the date of acquisition the fair value of the liabilities assumed exceeded the fair value of the assets acquired (a net deficit acquisition). Ms. Bielstein answered that the amount of goodwill recognized would be determined by the estimated fair value of the entity if that fair value could be reliably estimated, otherwise it would be determined by the acquiring organization's investment in the acquired entity (that is, the amount of the deficit). Ms. Bielstein gave the following example.

The acquired entity has a net deficit fair value of $100. If the acquiring organization can reliably determine the acquired entity's fair value to be $80, then goodwill of $180 would be recognized. If the acquiring organization cannot reliably determine fair value, then goodwill of $100 would be recognized.

The Board asked to defer a decision on whether goodwill should be recognized in a net deficit acquisition until it reaches a decision on post-acquisition recognition of goodwill.

<u>Summary for ACTION ALERT</u>:

Same as first four paragraphs under Matters Discussed, Decisions Reached, and Follow-Up Action.