SON OF SFAS 141

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On October 22 and 23, 2003, I was an observer at the joint meetings of FASB and the International Accounting Standards Board (IASB). They are now together undertaking several projects in a Phase II on Business Combinations. The objectives are to improve certain purchase accounting rules and practices so as to increase: (1) the transparency of information to users of financial statements, and (2) their consistency with FASB's Conceptual Framework.

These projects include reconsideration of certain aspects of purchase accounting that were not covered by SFAS 141; they are expected to result in an Exposure Draft in 2004 Q1 with a final expanded Standard in Q4. Topics to be covered will include:

1. Pre-acquisition Contingencies, both Assets and Liabilities.
2. Measuring the Fair Value of the Exchange.
3. Recognition and Measurement of Acquired Assets and assumed Liabilities.
4. Non-controlling Interest Issues.
5. Fresh Start Accounting.
6. Combinations of Not-For-Profit Organizations.
7. Mergers of Mutual Entities.

Items 1 to 4 are covered in FASB's Summary of Tentative Decisions (August 2001 through October 8, 2003) which is attached; the last three are discussed in this paper.

Fresh Start Accounting

In certain circumstances Fresh-Start, a new basis with Fair Value recognition and measurement of all of an entity's assets and liabilities, is appropriate. One common candidate would be a multiparty business combination or other new entity formation in which no single pre-existing organization obtains majority ownership and control; another is joint venture formation. Important issues include the recognition and measurement of Intangible Assets and Goodwill in transactions accounted for by this method.

During the fourth quarter of 2000, FASB discussed the recognition of a new basis of accounting in connection with the formation of a joint venture. It decided that a change from unilateral control over a group of net assets by one entity, to joint or shared control by it and one or more others should result in a new basis of accounting for the group in the Financial Statements of the jointly controlled entity. It decided that an investor that exchanges appreciated, or previously unrecognized, assets for an equity interest in a joint venture should recognize a gain or loss on the exchanges. Since then this project has been on hold.

Combinations of Not-For-Profit Organizations

Combinations of Not-For-Profit Organizations ("NFPO"s) are growing rapidly especially in the health care field. FASB believes that they should be brought under the new framework. The tentative decisions it has reached on expanding SFAS 141 to apply to combinations of NFPOs are:

- The definition of NFPO in SFAS 116 is to be used.
- SFAS 141 is presumed to apply unless a circumstance unique to those combinations is identified that would justify a different accounting treatment "differences-based approach".
- The expanded Standard will include: (a) combinations between two or more NFPOs and (b) the acquisition of a for-profit business by an NFPO. The acquisition of an NFPO by a business is already covered by SFAS 141.
- Combinations in which no entity dominates the process of selecting a voting majority of the combined entity's board (mergers of equals) will be covered.
- The following are to be excluded:
  - A transaction in which control is obtained through means other than by purchase or gift of net assets or equity interests.
  - The formation of a joint venture.
  - The acquisition of non-controlling interests.
  - A transfer of net assets or exchange of equity interests between entities under common control.
- The accounting treatment of combinations of NFPOs would differ from acquisitions of assets, subject to certain liabilities, based on whether the transferred set of processes and assets represents an activity.
- Although the definition of a combination transaction is based on a notion of control, this would not be specifically defined in the expanded Statement but the existing GAAP definition would be carried forward.

Accounting for a Combination of NFPOs

Combinations in which the acquiring entity is an NFPO, unlike those in which it is a business, cannot be assumed to be an exchange of commensurate value. Acquired NFPOs lack owners who are focused on receiving a return on, as well as of, their investments. Moreover, the parent or governing body of an acquired NFPO may place mission effectiveness ahead of maximum price when negotiating a combination, and may approve a transaction at less than Fair Value if that would maximize the resources available to further its objectives.

Similarly, but more rarely, the owners of a business may be motivated by donative intent to make a contribution to an NFPO by transferring equity interests for less than Fair Value. If an entity voluntarily transfers its net assets or equity to an NFPO in exchange for assets of substantially lower value, or without consideration, and no unstated rights or privileges are involved, the inherent contribution is to be reported in accordance with SFAS 116, "Accounting for Contributions Received and Contributions Made".

Some acquisitions by NFPOs may be very similar to those by businesses, if an entity is acquired in an exchange of commensurate value. In such cases, the combination is recorded under SFAS 141.

Determination of Reciprocalities

Whether a combination is reciprocal (an exchange of commensurate value) or nonreciprocal (containing an inherent contribution) should be determined for every transaction in which an NFPO is acquired:

Factors to Consider

The first two of the facts and circumstances set out below may provide evidence that the combination involves a contribution; the following five that it is reciprocal:

1. The net Fair Value of the assets acquired and liabilities assumed substantially exceeds that of the consideration exchanged and no unstated rights or privileges are involved.
2. There is evidence that the participants were acting as a donor and a donee in addition to being a seller and buyer.
3. The entity is acquired through a competitive bidding process involving multiple potential acquirers;
4. The consideration offered was developed in consultation with acquisition advisors or was based on an estimate of the acquired entity's Fair Value, either developed internally or independently;
5. The acquired entity's former parent, or predecessor board of directors, retained outside specialists to assist in negotiating the combination, or used estimates of the organization's Fair Value to evaluate the adequacy of the offers received;
6. One or both parties to the combination retained consultants to provide an opinion on the fairness of the consideration paid and received;
7. The provisions of NFPO law or involvement of a regulatory body influenced the terms, or structure, of the combination to ensure that Fair Value was obtained.

Accounting Treatment

- On the purchase of an NFPO, the contribution recognized by the acquirer would be the excess of the net Fair Values of the identifiable assets acquired and the liabilities assumed over the Fair Value of the consideration (if any).
- If the sum of the Fair Values of the liabilities assumed exceeds that of the identifiable assets acquired, the acquiring organization should initially recognize that excess as goodwill.
- When the acquired entity is a business, the inherent contribution is the excess of the Fair Value of the acquired business over its cost.
- Communities neither own nor control NFPOs and, therefore, their relationships with an NFPO has no effect on the accounting for a combination of NFPOs.

Consideration in a Combination of NFPOs

In general, assets transferred, or liabilities incurred, by the acquiring organization in a combination of NFPOs should be accounted for as consideration paid unless the acquirer retains control over the future economic benefits of the transferred assets. Under these circumstances, the transfer is an asset-for-items exchange. Examples include if the assets are transferred:

1. subject to being repayable or refundable;
2. to a recipient that is controlled by the acquirer;
3. with the stipulation that they be used on behalf of, or for the benefit of, the acquired organization, the acquirer, the resulting combined entity or their affiliates.

An acquiring NFPO should account for a regulatory-required asset transfer as consideration paid for the acquired organization. Contingent consideration in a combination should be accounted for in accordance with the proposed guidance in the "Summary of Tentative Decisions".

Identifying the Acquirer

In determining which is the acquiring organization in a combination of NFPOs, and there must be one, all pertinent facts and circumstances should be considered. In a transaction effected solely through distributing cash or other assets or by incurring liabilities, the organization that makes the distribution or undertakes the liabilities is generally the acquirer.

In an NFPO combination in which no consideration is exchanged, the one that is able to dominate the process of selecting a voting majority of the combined organization's initial governing body is the acquirer. In determining if an organization has the ability to dominate the selection process, consideration should be given to: (a) the rights provided by the combined organization's articles of incorporation, by-laws, or provisions in the combination agreement, to elect or appoint members to the combined organization's governing body: and (b) the ability to dominate the selection process through other means.

Other factors to consider in deciding which is the Acquirer:

1. If the combined organization's articles of incorporation or by-laws state that the members of the governing body are appointed, whether one of the combining organizations has the right to appoint a voting majority.
2. If the combined organization governing body is self-perpetuating:
   - Whether one organization negotiated the right to select a voting majority of the combined initial governing body, or
   - One organization has the ability to dominate the selection of a voting majority of the initial governing body through means other than negotiated rights, such as disproportionate representation on the committee that selects nominees for that body.
3. If the initial governing body is elected by the combining organization's members, whether one set of members have the majority of the voting rights.

4. Any other rights to appoint or designate members of the combined organization's governing body either as of the combination date or in the near future, such as upon the expiration of the terms of some or all of the initial members.
5. If positions on the governing body are designated, their effect on the ability of one organization to appoint a voting majority of the combined entity's governing body.
6. The powers of sponsoring organizations or corporate members and their composition, together with their effect on the ability of one organization to control the resulting entity.
7. If the governing body delegates corporate powers to committees, the nature of those powers and the composition of the committees.
8. The effect of voting requirements (such as super majorities) on the ability of one organization to appoint or dominate the selection of the governing body.
9. The composition of senior management, in particular the factors considered by the combining organizations in selecting that team.

The carrying over of a name and the relative sizes of the parties to the combination are other possible indicators for identifying the acquirer, but are not required to be considered in all transactions.

Accounting for Goodwill

On March 17, 2003 FASB decided that goodwill should be recognized in nonreciprocal combinations of NFPOs, only to the extent that the Fair Value of the liabilities assumed exceeds the Fair Value of the assets acquired, that is, the net deficit acquired.

It decided on a two-path method of accounting for goodwill subsequent to acquisition, if the acquired entity is another NFPO or is a business that will be converted to an NFPO.

1. Reporting Units primarily supported by fees or other charges for goods and services should test goodwill for impairment using the Fair Value method required by SFAS 142.
2. Reporting Units not primarily supported by charges to third parties should test goodwill for impairment using a trigger-based method; this writes it off in its entirety if particular events occur. At the date of acquisition, the acquiring organization should identify the reasons goodwill arose and determine suitable triggering events, related to those reasons that would indicate that goodwill is significantly impaired.

For a combination in which an NFPO acquires a business enterprise that will continue to be operated as such, FASB decided that goodwill should be tested in accordance with SFAS 142.

The criteria in paragraph 39 of SFAS 141 for recognizing identifiable intangible assets should be applied in the combinations of NFPOs.

Collection Acquired in a Combination

FASB decided that SFAS 116 would continue to apply for collection items that are contributed to, or purchased by, an NFPO. It determined that when items are acquired in connection with a combination of NFPO's, the acquirer should also follow SFAS 116 in accounting for items acquired for its inexhaustible collection.

Financial Statement Presentation

FASB decided that the acquisition of an NFPO should be reported as follows:

Statement of Activities

- The contribution resulting from a nonreciprocal transaction should be reported in the Statement of Activities as a separate line item; it should be treated as an increase in permanently restricted, temporarily restricted or unrestricted net assets depending on the donor-imposed terms.
- Limitations placed on net assets by the governing board of an acquired entity in a nonreciprocal combination should be reported as donor-imposed restrictions only if they are (a) imposed as conditions of the transaction, (b) irrevocable, and (c) not self-imposed. Generally, such limitations should be deemed self-imposed if members of the governing board of the acquired entity make up a significant portion of that of the combined organization. They should be deemed not self-imposed if the acquired entity was only a portion of another entity and that other entity continues unaffiliated. Limitations placed by the governing board of the acquiring entity should not be reported as donor-imposed.
- An acquirer should not apply the reporting exception in paragraph 14 of SFAS 116. Instead, it should report its assumption of fiduciary responsibilities for the restricted net assets of the acquired entity separately from any expiration of those restrictions that occurs after the date of acquisition and before the end of the reporting period.
- For reciprocal combinations, an acquirer should report changes in net assets that result from its assumption of fiduciary responsibilities for the restricted net assets of the acquired entity as a separate line in the Statement of Activities.

Statement of Cash Flows

- A nonreciprocal combination in which no consideration is exchanged should be reported as a noncash activity in accordance with paragraph 32 of SFAS 95, "Statement of Cash Flows"; if cash is one of the assets acquired, it should be treated as an investing activity.
- The net cash outflow for a reciprocal combination should be reported as an investing activity.
- If the combination is partly a purchase and partly a contribution, the net cash outflow should be reported as an investing activity and the remainder as a noncash activity in accordance with paragraph 32 of SFAS 95.

Disclosures Required by SFAS 141

Paragraph 51

X1. In the period in which a material combination is completed:

1. The name and a brief description of the acquired entity and whether the acquirer obtained the entire entity or only a portion; if a portion, it shall be identified.
2. The Fair Value of the consideration paid for the acquired entity, or if none, that fact.
3. The primary reasons for the transaction, including a description of the factors that induced consideration with a Fair Value in excess of that of the assets acquired and liabilities assumed, or, if no consideration is paid, to assume liabilities with a net Fair Value in excess of that of the assets acquired, thereby resulting in recognition of goodwill.
4. The period for which the revenues, expenses, gains, losses, and reclassifications of the acquired entity are included in the Statement of Activities of the combined entity.
5. The Fair Value of the assets acquired (including goodwill) and the liabilities assumed in the form of a condensed balance sheet at the closing date, disclosing the amounts for each major asset and liability line of the acquired entity.
6. If the determination of the Fair Value of assets acquired (including goodwill) and liabilities assumed has not been finalized, that fact and the reasons why. In subsequent periods, the nature and amount of any material adjustments made to the initial determination shall be disclosed.

Paragraph 52

X2. In the period in which a material business combination is completed if the amounts assigned to goodwill or to other intangible assets acquired are significant in relation to the aggregate Fair Value of the assets of the acquired entity:

1. For intangible assets subject to amortization:
    a) The total and the amounts assigned to each major intangible asset class.
    b) The amount of any significant residual value, in total and by major asset class.
    c) The weighted-average amortization period, in total and by major asset class.
2. For intangible assets not subject to amortization, the total and the amounts assigned to each major asset class.
3. For goodwill, the amount and, if Reporting Units to which goodwill is allocated are subject to taxes, the figure that is expected to be deductible for tax purposes.

Paragraph 53

X3. If a series of individually immaterial combinations during the period are material in the aggregate:

1. The number of entities acquired and a brief description of them.
2. The aggregate Fair Value of the consideration paid for all the acquired entities, or if no consideration was paid, that fact.

3. The information described in paragraph X2, if the aggregate amount assigned to goodwill or to other intangible assets acquired is significant in relation to the aggregate Fair Value of the assets of the acquired entities.

Paragraph 57

The notes to the financial statements also shall disclose the information required by paragraphs X1 and X2 above if a material combination is completed after the Balance Sheet date but before the Financial Statements are issued, unless this is not practicable.

Other Paragraphs

- Contingent payments, options, or commitments - paragraphs 51 (f) and 53 (d).
- Purchased research and development costs - paragraph 51 (g).
- Extraordinary gains recognized in a combination - paragraph 56.

Disclosures Unique to NFPOs

In addition to the disclosures required by SFAS 141, FASB decided that NFPOs should disclose:

- The Fair Value of items acquired in a reciprocal combination and then written off in the same period.
- The reasons goodwill arose in an acquisition and the triggering events that would result in its write-off, if the Reporting Unit(s) acquired are not primarily supported by charges.

Remaining Issues

A few items remain to be decided before an Exposure Draft may be issued:

1. Whether the definition of an "activity", as that term will be used to distinguish a combination from a purchase of assets subject to certain liabilities, should include the notion of self-sufficiency.
2. If a fee-supported NFPO, acquired in a nonreciprocal transaction, should be initially recognized at the Fair Value, including goodwill, received or at the net Fair Value of the assets acquired, excluding goodwill, less the liabilities assumed.
3. Should guidance be supplied for post-acquisition accounting for goodwill when (a) a Reporting Unit no longer qualifies for the SFAS 142 impairment test because it ceases to be primarily supported by fees or (b) a Reporting Unit no longer qualifies for the trigger-based method because it has become primarily supported by fees.
4. The pro forma information about a combination that should be disclosed by an NFPO, and whether such requirements apply to all, or only certain, organizations.
5. The type of guidance, if any, that should be provided for measuring the Fair Value of the organization in the absence of market transactions.

Combinations of Mutual Enterprises

The glossary of SFAS 141 defines a mutual enterprise as "an entity other than an investor-owned entity that provides dividends, lower costs, or other economic benefits directly and proportionately to its owners, members, or participants". Mutual insurance companies, credit unions, and farm and rural electric cooperatives are examples.

The application of SFAS 141 and 142 to combinations between mutual enterprises was deferred to allow FASB time to consider whether any unique attributes of mutual enterprises justify an accounting treatment different from that in those Statements.

Therefore paragraph 60 of SFAS 141 states that it is not effective for such combinations until further interpretive guidance is issued; this is not expected until 2004. As a result APB 16 and 17, together with related documents (including but not limited to, FASB Interpretations and AICPA Audit and Accounting Guides) continue to apply and Pooling is still allowed.

Reasons for Delay

The following were among the reasons for the delay:

- Some combinations between mutual enterprises have characteristics that distinguish them from other business combinations. The most notable variances are the absence of equity and investors, and the lack of a readily identifiable and measurable monetary consideration, FASB is expected to presume that the provisions of SFAS 141 and 142 apply to combinations between mutual enterprises, unless conditions of the combination are so different as to warrant another accounting treatment. Differing interpretations as to how APB 16 should be applied, have led to diversity in practice.
- SFAS 141 eliminated pooling-of-interests, yet, in practice, many combinations of mutual enterprises are accounted for in a manner similar to that method.

Accounting for a Combination of Mutual Enterprises

In such a combination, the initial Fair Value of the transaction is an issue because generally only member interests are exchanged and no observable and measurable exchange price is available. FASB decided that the Fair Value of the acquired enterprise taken as a whole should be used. This is consistent with paragraph 6 of SFAS 141, based on APB 16, paragraph 67, which provides that, ".... if the consideration given is not in the form of cash (that is, in the form of noncash assets, liabilities incurred, or equity interests issued), measurement is based on the Fair Value of the consideration given or the fair value of the asset (or net assets) acquired, whichever is more clearly evident and, thus more reliably measurable".

In accounting for the acquisition of a mutual enterprise, the Fair Value of the acquired entity should be reported in the Financial Statements of the acquirer as a direct addition to a capital account, appropriately labelled and identified as arising from the transaction. FASB decided that the amount and nature of the addition to capital, as well as the basis for determining the Fair Value of the acquired entity, should be disclosed.

Son of SFAS 141

The criteria in SFAS 141 should be used to identify the acquirer and the criteria in paragraph 39 of SFAS 141 relating to identifiable intangible assets should also be applied.

The guidance in SFAS 72, Accounting for Certain Acquisitions of Banking or Thrift Institutions, and FASB Interpretation No. 9, "Applying APB Opinions No. 1 and 17 When a Savings and Loan Association or a Similar Institutions Acquired in a Business Combination Accounted for by the Purchase Method", as it relates to combinations between mutual enterprises is to be rescinded.