



## ACCOUNTING ALERT

2010-01

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### Not-for-profit Entities Face New Business Combination Rules

#### Background

A new accounting standard was issued by the FASB in 2009<sup>1</sup> that changes how not-for-profit entities account for business combinations. The new rules also change the manner in which not-for-profit entities account for changes in a parent's ownership interests in consolidated subsidiaries after control is obtained<sup>2</sup>.

Similar changes were implemented by for-profit entities in 2009<sup>3</sup>. However, those rules were not applicable to not-for-profit entities. The delay in guidance around mergers and acquisitions for not-for-profit entities was to give the FASB time to consider the significant differences between business combinations of for-profit entities and those of not-for-profit entities.

#### Differences between a Merger and Acquisition

The new business combination rules for not-for-profit entities, while similar in many ways to those used by for-profit entities, have some significant differences. The biggest difference is that not all business combinations entered into by not-for-profit entities are considered acquisitions. Some business combinations by not-for-profit entities do not involve the exchange of consideration and are consummated primarily to further the mission and/or programs of the not-for-profit entity.

When the governing bodies of two or more not-for-profit entities cede control of those entities to create a new not-for-profit entity, it is deemed to be a merger for accounting purposes. Mergers will be accounted for using the carryover method, which is based on the historical cost information of both entities. In contrast, when a not-for-profit entity obtains control of one or more nonprofit activities or businesses, it is considered an acquisition.

Not all acquisitions involve the exchange of consideration. Some acquisitions involve nonreciprocal transfers. In some cases, those transfers will result in a contribution to the net assets of the not-for-profit entity. Acquisitions will be accounted for using the acquisition method, which follows the same rules used by for-profit entities with some notable exceptions.

<sup>1</sup> Accounting Standards Codification (ASC) 958-805, formally FASB Statement No. 164, *Not-for-Profit Entities: Mergers and Acquisitions* – Including an amendment of FASB Statement No. 142.

<sup>2</sup> Accounting Standards Updated (ASU) No. 2010-07

<sup>3</sup> ASC 810-10-65, formally FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements (as amended)*



## Mergers and the Carryover Method

When two not-for-profit entities undertake a business combination that qualifies as a merger, a new reporting entity is formed for accounting purposes. The new entity's financial statements carry forward the assets and liabilities of the two combining entities as of the merger date. No new assets or liabilities are recorded as a result of the merger nor are the combining entities required to re-measure at fair value any assets or liabilities. And the two prior reporting entities cease to exist.

The only adjustments that are required are those that result from conforming differences in accounting policies between the two merged entities. The carryover method differs from the concept of pooling-of-interests, since it does not restate any pre-merger financial information and the carryover method requires the new entity's reporting period to be as of the merger date, not as of the beginning of the period in which the merger occurs.

## Acquisitions in the Acquisition Method

When a not-for-profit entity obtains control of one or more nonprofit activities or businesses, the not-for-profit entity will account for the transaction using the acquisition method for business combinations set forth under ASC 805-10, with certain exceptions and additional guidance for those items which are unique to not-for-profit entities.

The primary area which differs from the acquisition method applied by for-profit entities relates to the recognition of goodwill. Goodwill is not recognized in acquisitions by those not for-profit entities which are solely or predominately supported by contributions and return on investments and any "goodwill" would be recorded as an immediate charge to the statement of activities. On the other hand, goodwill is recognized by those not-for-profit entities which are more business oriented<sup>4</sup>.

Other notable provisions of the acquisition method that are specific for not-for-profit entities include the following:

- *Donor relationships* – No separate intangible asset is recognized for acquired donor relationships.
- *Collections* – If the not-for-profit entity does not capitalize collections (works of art, historical treasures, or similar assets) then no asset shall be recorded for an acquired collection. Rather the cost of the acquired collection would be accounted for as a decrease in net assets in its statement of activities.
- *Conditional promises to give* – assets related to conditional promises to give should not be recognized unless the conditions on which they depend are substantially met, that is, when the conditional promise becomes unconditional.<sup>5</sup>
- *Contributions received* – with the exception related to collections noted above, the acquirer shall recognize the excess of the fair value of net assets received over the fair value exchanged as a credit in its statement of activities as of the acquisition date.

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<sup>4</sup> ASC 958-805-25-22

<sup>5</sup> Accounting guidance around conditional promises to give is outlined in ASC 958-605-25-11 through 25-15, formally FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*.



## Acquisition Costs

Consistent with the accounting by for-profit entities, the new rules now require acquisition related costs to be expensed by not-for-profit entities.

## Noncontrolling Interests

A further impact of the new accounting standard is how not-for-profit entities are required to account for changes in a parent's ownership in consolidated subsidiaries. Net assets attributable to the noncontrolling interest are recorded at their fair value when the subsidiary is first consolidated. Once consolidated, all future changes in the parent's ownership percentage are accounted for as transactions within the net asset section of the balance sheet.

The guidance also extends the other aspects of accounting for noncontrolling interests to not-for-profit entities. Beginning in 2010, not-for-profit entities will include noncontrolling interests of all of its consolidated subsidiaries as a component of its net assets.

The change will also impact the presentation earnings applicable to noncontrolling interests in the statement of activities. The net increase or decrease in net assets in the statement of activities previously excluded the portion attributable to noncontrolling interests. Under the new rules, the portion attributable to noncontrolling interests will now be included in the net increase or decrease in net assets. Supplementary information will then be provided within the statement of activities to clarify the portion of the net increase or decrease attributable to both the noncontrolling interest and the not-for-profit reporting entity.

## Effective date

The new rules become effective for business combinations that occur in fiscal years which begin after December 15, 2009. The accounting changes affecting the presentation of noncontrolling interests are also effective for fiscal years which began after December 15, 2009.

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