

Mergers

made simple



July 2015

Sayer Vincent LLP

**Chartered accountants
and statutory auditors**

Invicta House

108–114 Golden Lane

London EC1Y 0TL

Offices in London, Bristol and Birmingham

020 7841 6360

svinfo@sayervincent.co.uk

www.sayervincent.co.uk

 [@sayervincent](https://twitter.com/sayervincent)



Published by Sayer Vincent LLP

Chartered accountants and statutory auditors

Limited liability partnership registered in England and Wales
OC390403

Copyright © Sayer Vincent

All rights reserved

No part of this publication may be reproduced by any means, or transmitted, or translated into a machine language without prior permission in writing from the publisher. Full acknowledgement of the author and source must be given.

Sayer Vincent shall not be liable for loss or damage arising out of or in connection with the use of this publication.

This is a comprehensive limitation of liability that applies to all damages of any kind, including, (without limitation), compensatory, direct, indirect or consequential damages, loss of data, income or profit, loss of or damage to property and claims of third parties.

www.platform1design.com

Introduction	5
Alternatives to merger	6
Merger process	7
Step 1 <i>Feasibility study</i>	8
Step 2 <i>Memorandum of understanding</i>	9
Step 3 <i>Due diligence</i>	10
Legal forms of merger	12
Employees and pensions	14
Involving the Charity Commission	15
Accounting considerations	16
Tax implications from merger	18
Conclusion	19
Further information	20
Notes	21

Introduction

Trustees must manage their charity's affairs in the best interests of beneficiaries – both current and future. They should therefore consider from time to time if these needs are best met by merging with another charity.

Potential merger partners usually set up a working group to carry out a feasibility study to look at cultural fit, legal issues, benefits, risks and the likely costs. If all sides are still interested, the next stage is likely to be to draw up a memorandum of understanding, including a confidentiality agreement, and a timetable to merger.

An investigation into the merger partner(s), usually referred to as due diligence, is required to ensure trustees understand what assets, liabilities and risks they are taking on in the merger so they are able to make an informed decision about progressing the talks. Accountants and solicitors will often be hired to assist with some or all of the due diligence process.

The charities will need to decide whether both charities merge into a new vehicle, if one merges into the other or if a group structure is best.

Merger and collaborative working are often mentioned in the charity sector. Often a period of collaborative working may be a first step to a merger, but is quite different both from a practical and legal perspective. A separate guide on collaborative working is available.

In this guide, the term merger is used to refer to the process whereby the resources of previously independent charities are brought under common control. It includes what in the commercial world would be regarded as acquisitions as well as true mergers.

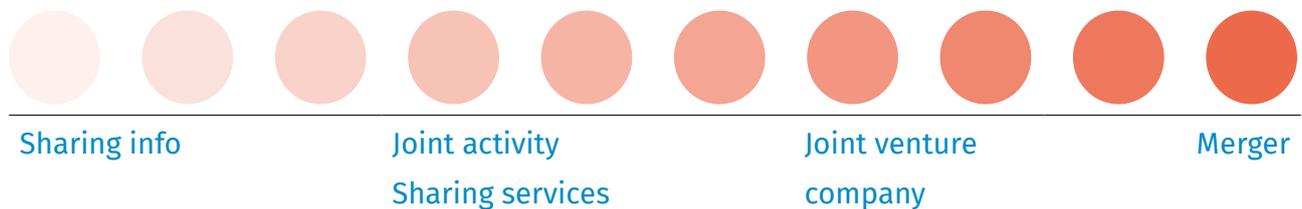
Charity mergers differ in many important respects from mergers in the commercial world. There is usually no consideration paid for any acquisition and most mergers are amicable and sought by all the parties involved. The primary motivation is usually not financial gain but the maintenance or improvement of services to beneficiaries.

Alternatives to merger

There are a number of ways in which charities can work together without actually merging. For example:

- Informal arrangements such as joint committees, information sharing, advice and support networks
- Sharing of resources under a formal agreement such as sharing premises, assets or staff, outsourcing arrangements, jointly arranged events and joint bids for funding
- Setting up a separate legal entity to undertake a joint project, for example a joint venture company set up to own and manage a shared asset
- Federations where similar charities join together to co-operate closely whilst remaining legally independent

Trustees must always consider why they want to merge and if there is a better alternative. Other forms of joint working may achieve the desired result and be less risky, easier to exit and less costly to set up. They can also be important preliminaries to merger, indicating that the charities concerned are compatible and capable of working together successfully. There are many levels of collaboration possible, from informal information sharing which involves no contractual arrangements to full merger. Even if the longer term plan is to merge, then there are many options for how a merger is achieved. In addition, it may be useful to think about closer working for a period of time before commencing the legal process of merger.



Merger process

The merger process can usually be broken down into five steps:

- 1 Feasibility study** undertaken to establish whether the merger is likely to work and deliver real benefits and to identify the major risks and potential problems. Issues usually dealt with in the feasibility study include cultural fit, legal difficulties, the legal form that the merged entity will take, and an analysis of the costs, benefits and risks of merger.
- 2 Memorandum of understanding** likely to include the objective of the merger, the outline merger plan and timetable, what each party will do and how the merger costs will be shared, a communications strategy, a confidentiality agreement and establishing a merger committee to oversee the process.
- 3 Due diligence** each board of trustees must gain assurance that the merger really is in the best interests of their charity and that any risks have been properly identified and addressed.
- 4 Proceeding to merger** on completion of due diligence and assuming the due diligence does not throw up any insurmountable problems, the trustees of the merging parties will be in a position to settle the final merger terms and proceed with the merger.
- 5 Post merger** once the merger has happened in legal terms, this is not the end. Full implementation can take many years, especially if complex service reorganisation is involved.

The first three steps are explained in more detail below.

Step 1 *Feasibility study*

Cultural fit

Perhaps the most significant barrier to successful merger is lack of “cultural fit”. Many charities rely on the goodwill of their stakeholders (beneficiaries, trustees, employees, volunteers, members, patrons, funders etc) and simply could not function without this. The merger partners need to assess if they will be able to work together successfully and without alienating key stakeholders.

Legal issues

There are many potential legal problems with a merger. For example, a transferor charity must have the power to transfer its assets and there must be a sufficient degree of compatibility between the objects of the merger partners. It is usually advisable to consult with a charity lawyer or with the Charity Commission at an early stage. It is usual to start considering the appropriate legal structure at an early stage.

Benefits and risks

An outline assessment needs to be made of what the merged entity will look like, what its activities and costs will be and how they will be funded. Any significant risks or uncertainties should be identified and assessed. SWOT analyses (to look at strengths, weaknesses, opportunities and threats) and risk assessments can be useful tools for identifying potential issues.

Costs of merger

A realistic assessment of the merger costs should be made and funding identified. Some trusts may be prepared to provide grants to support a merger. Merger costs typically include professional fees, the costs of obtaining member consent, the costs of reorganising service provision, redundancy payments, relocation costs, re-branding, the costs of merging IT systems and the opportunity costs of disruption, lost opportunities and of trustee, staff and volunteer time spent dealing with the merger.

Step 2 Memorandum of understanding

It is helpful if the key aspects of the agreement are formally set out in a memorandum of understanding. This helps to ensure that trustees who are less closely involved can see what has been agreed and avoid the same issues being raised again.

Merger plan

An outline of the objective of the merger including, if appropriate, the legal form of the merged body, its constitution, governing body, staff structure and activities. An outline of the actions to be taken to achieve the merger, together with a timetable and details of how the merger costs will be shared.

Communications strategy

Without a carefully planned communications strategy, rumour and speculation may take over and severely disrupt or derail a merger. The strategy should address how the merger will be communicated to all key stakeholders including beneficiaries, staff, volunteers, members and funders.

Confidentiality agreement

As part of the merger process the partners will have to share sensitive information with each other. All such information should be provided under the terms of a confidentiality agreement.

Merger committee

Merger partners often form a joint committee to manage the merger process. The committee is usually composed of agreed numbers of trustees and senior staff from the merger partners. An independent facilitator or project manager can be useful if there are likely to be disagreements or complications. The committee's role is to oversee the merger process and report to each of the trustee boards. However, final decisions must always rest with the trustees so the terms of reference and delegated powers of the merger committee need to be agreed at the outset.

Timetable

Merger discussions need to progress at a reasonable pace if they are to lead to a successful conclusion. On the other hand, a rushed process at the early stage may mean that all relevant information is not available to trustees and mistakes are made. It is wise to consider the appropriate timetable after the feasibility study. At that stage, the parties will have agreed to go a step further, but there is more work to do and there may be conditions to meet. Trustees may wish to set a deadline for the merger as there may be important contracts or other arrangements that are affected by such a significant change.

Step 3 *Due diligence*

Due diligence is the process whereby each set of trustees seeks to gain assurance that the merger is in the best interests of their charity's beneficiaries and that it will not expose the charity's assets or its beneficiaries to undue risk. Both sets of trustees must undertake due diligence procedures and consider:

- For a transferor charity: is the transferee a safe home for the charity's assets?
- For a transferee charity: what risks and liabilities is it taking on?

Both aspects will apply if it is a genuine merger and a new entity is being created. The nature and extent of due diligence procedures will be governed by the size of the charities involved and the risks and complexity of the merger. In larger or more complicated mergers, the trustees will usually want to appoint external advisors, usually accountants and solicitors, to assist with due diligence. External advisors can also provide an objective viewpoint and deal with the difficult issues that must be addressed. Due diligence is likely to cover:

Background and governance

- Overview of external environment and competition
- Organisational structure – governance and management
- Review of the strategic planning document and risk register

Management and people

- Details of all staff, job titles, gross pay, pension contributions, length of service etc
- Details of contracts of employment, staff policies and manual
- Staff relations and details of any trade union representation
- Details of volunteers and related policies

IT and accounting systems and management information

- Analysis of age and suitability of IT systems
- Overview of internal controls and financial procedures manual
- Management letters from auditors and board responses

Financial information

- Audited accounts, management accounts, budget and cash-flow forecasts
- List of current funders and projects being funded and for how long
- Assessment of rate of return on fundraising activities
- Review of VAT and other tax compliance and any implications
- Review of restricted and unrestricted funds

Assets and liabilities

- An analysis of and comments on the main assets and liabilities
- Details of occupied premises, terms of tenure and usage
- Copies of land registry certificates confirming ownership
- Details of dilapidations if material
- In the case of any let properties, details of tenants and terms
- Details of other contracts in existence, such as leased equipment
- Current or threatened litigation or other contingent liabilities
- Banking facilities available
- Insurance cover
- Staff pension arrangements and any deficits, surpluses and guarantees on pension schemes

Post-merger issues

- Pro-forma post-merger consolidated balance sheet and statement of financial activities with relevant commentary
- Financial projections for the merged charity going forwards
- Any consents necessary from regulators
- Attitude of funders, partners, beneficiaries and other stakeholders
- Any other factors which might materially affect merger prospects

The purpose of due diligence is to provide each board with enough information to enable them to make a decision about whether the merger is in the best interests of their beneficiaries. Each board needs to receive a report on the merger partner which provides both an overview and sufficient detail for the decision to be made.

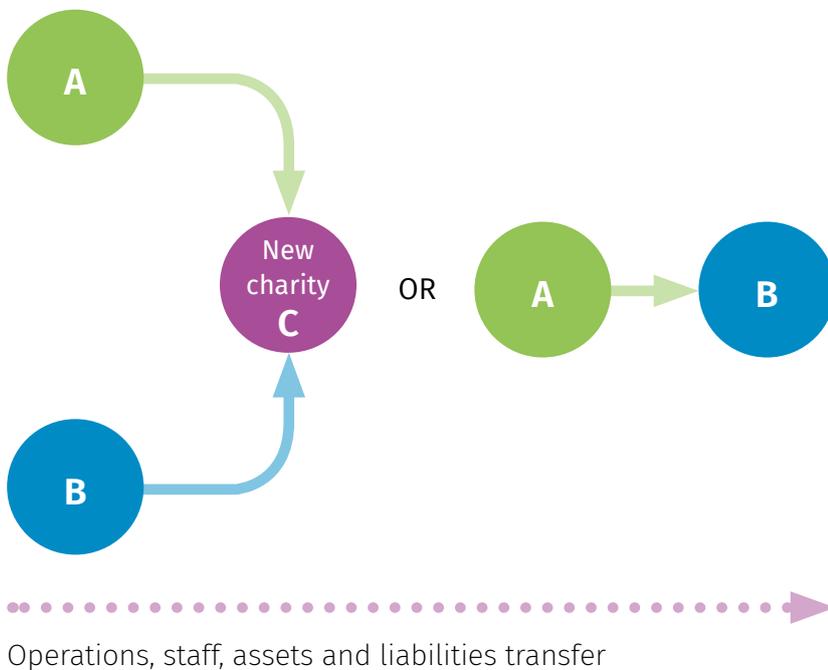
It is common for independent advisors to prepare due diligence reports for all parties and provide reports to each board. Because there can be some overlap, it is wise to ensure that the legal advisors and accountants can work well together to avoid duplication and excessive fees.

Legal forms of merger

One of the key decisions that must be taken early on in the merger process is what legal form it will take. There are two basic types of merger:

Transfer of assets

This involves one charity (the “transferor”) transferring its assets to the other (the “transferee”) or both charities transferring their assets to a newly created charity. Another variation is that after transfer, the transferee changes its name and adopts new governing documents.



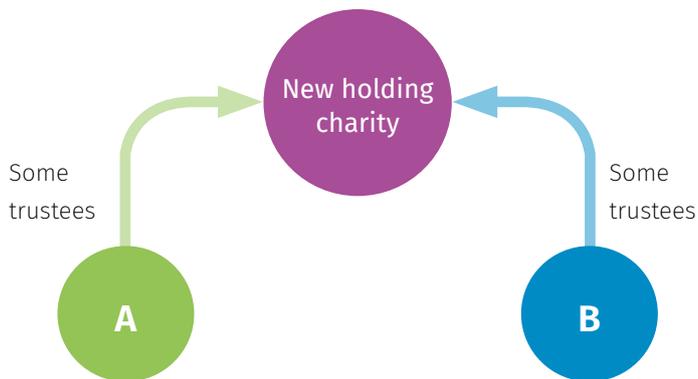
Transfer of ownership or group structure

Here all assets remain within the respective separate legal entities, but ownership of the entities is changed. For example, one charity (charity A) may become sole corporate trustee or member of the other (charity B). Charity B becomes a subsidiary of charity A though in return some of B's trustees may be appointed to the board of charity A.

A variation is for a new charity to become sole corporate trustee or member of both charities with its board being made up of trustees from A and B. There will still be separate legal entities with their own employees and assets requiring separate registration, board meetings, accounts etc.

The advantages of a group structure are:

- It can be created quickly and be a stage in an merger
- It allows the continuation of existing contracts and pension arrangements
- Non-charity entities can be in a group structure as subsidiaries



Employees and pensions

If employees are being transferred, the Transfer of Undertakings (Protection of Employment) regulations 2006, known as TUPE almost certainly apply. Depending on the structure the merger takes, the identity of the employer of at least one, if not both, charities will change. The employees of the transferor automatically become employees of the transferee on the same terms and conditions as in the previous charity and continuity of employment is preserved.

The transferor must provide the transferee with full details of the employees being transferred, requiring a review of all contracts of employment and working practices, which may effectively have become terms of employment. You also need to check for workers who are not treated as employees but may have employment rights.

The information employers are obliged to provide will include confirmation of the merger, the date when the merger is proposed to take place and the reasons for it, as well as the legal, social and economic impact of the transfer. Although there is no prescribed time limit as to when this information must be given, it must be provided in enough time before the transfer to allow consultation to take place. TUPE also imposes a duty on both the transferor and transferee to consult with representatives of their employees that may be affected by the transfer. The employer must consider any representations made and if the representations are rejected, the employer must state the reasons.

Employees involved in a TUPE transfer will be eligible for pension protection where:

- the employee is (or is eligible to be) an active member of an occupational pension scheme provided by the transferor employer; and
- the scheme provides money purchase benefits that the transferor is required, or even if not required, has made one or more contributions to the scheme in respect of the employee.

For employees who are eligible for pension protection, following the transfer, the eligible employees must be offered membership of either:

- A final salary (defined benefit) pension scheme that provides benefits which equate to at least 6% of pensionable pay for each year of employment or the employer makes contributions on behalf of its employees subject to an upper limit of 6% basic pay; or
- A money purchase (defined contribution) pension scheme or a stakeholder pension arrangement, to which the employer must make a matching contribution of up to 6% of actual gross basic pay.

The pension regulations are designed to protect employees who would otherwise lose their pension rights because of a TUPE transfer.

In most situations involving a transfer of employees it will be necessary for both parties to take legal advice at an early stage in order to ensure that the correct procedures are followed throughout.

Involving the Charity Commission

The majority of charity mergers do not require the consent of the Charity Commission, but they will need to be involved if a charity does not have sufficient powers to proceed with a merger or if a charity's own governing document includes a specific requirement to seek Charity Commission consent when merging or dissolving.

Usually a charity's governing document will include the necessary power for it to merge with another charity.

Register of mergers

The register of mergers is held on the Charity Commission website and includes those charities that have informed the Charity Commission that they have merged with or transferred assets to another charity and ceased to exist.

Only "relevant mergers" can be registered. These are where:

- one charity transfers all its assets to another charity then ceases to exist
- two or more charities transfer all their assets to a new charity then cease to exist
- an unincorporated charity winds up and passes its assets to a newly formed charitable company

Mergers may only be registered once all of the transferees have completed their transfers. One important reason for keeping "shell" charities in the past was to receive legacies and gifts due to the old charity. Now, once a relevant merger is registered, most legacies and gifts made out to a transferor charity will be able to be applied to the transferee.

This does not apply in certain situations where the transferor has permanent endowments and the gift relates to those endowments. In addition, not all types of merger can be registered, so there are situations in which shell charities will still have to be left open.

Being on the register of mergers means that donations such as legacies can be transferred to the new charity. You should notify the Charity Commission when any charities are dissolved so that the register of charities can be updated.

This is an area where your solicitor can provide further advice. Some legacies may be worded in a way that specifies another recipient for the legacy. In these cases, the gift would not automatically transfer to the new charity but go to the person or organisation specified in the will.

Vesting declarations

A vesting declaration is a deed which transfers the title of the property of a charity from the transferor to the transferee. This simplifies the process of transferring property as the transferor can simply list all the assets which are to be vested in the transferee, rather than have to vest each asset separately. However, a vesting declaration cannot be used for certain types of asset.

Registering a merger is compulsory where a vesting declaration is used.

Permanently endowed assets, property subject to covenants or special trusts will all need specific legal advice and may involve an approach to the Charity Commission.

Accounting considerations

The accounting considerations here are relevant to charities preparing accounts in accordance with the charities SORP and FRS102. FRS 102 sets out two methods of accounting for a business combination:

- **acquisition accounting** one party acquires another
- **merger accounting** two or more parties combine on an equal footing.

The criteria in FRS 102 sections 19 and 34 and SORP section 27 should be used to determine whether the new organisation should apply merger accounting, summarised as follows:

Tests/Criteria	Merger	Acquisition
Relationship of parties	Equal parties	Acquirer/acquiree
Participation of parties in the combination	All parties involved in decisions	Decision based on voting rights
Relative size (relative size can be viewed from a number of perspectives: income, net assets/funds, staff numbers, members)	No one party dominates	Parties disparate
Consideration	Charity merger – no consideration	Some form of payment
Future retained interests	No interest kept by individual party	Material interest retained

Accounting for a merger

The application of merger accounting will affect the presentation of the accounts, such that you create a financial picture in the accounts as if the new organisation had always existed. The results and cash flows for the merging charities should be brought into the financial statements of the combined entity. The corresponding figures should be restated by including the results for the combining charities for the previous year end, including their balance sheets at the previous year end.

In order to prepare group accounts, the accounting policies for the merging charities

will need to be aligned. A careful review of the accounting policies of the individual combining charities should be undertaken to identify any key items, to ensure the accounting policies are aligned.

The fundamental principle of merger accounting is that the accounts for the new organisation are prepared as if the merger had always been in existence. It is a simple aggregation of the assets and liabilities at their carrying values, with the prior year comparative figures being that of the combining entities added together.

Accounting for an acquisition

The SORP requires combinations that do not meet the criteria for a merger to be treated as an acquisition. Under acquisition accounting, the assets and liabilities transferred are adjusted to fair value. The fair value is the amount that would be exchanged for an item in an arm's length transaction in an open market, so may be different to carrying value. In particular, properties and equipment may need to have their book values assessed on acquisition.

An acquisition may in substance be a gift, where the assets and liabilities of one charity are transferred to another at nil or nominal consideration. If the fair value of the assets received exceeds the fair value of the liabilities, then there is a gain that should be recognised as income within donations. If net liabilities are transferred, then the loss should be written off in the receiving charity as charitable expenditure.

Where the combination is not a merger nor a gift, it must be accounted for as an acquisition, with any negative goodwill written off in the reporting period of acquisition.

Restricted funds

Obviously restricted funds transferred in a merger will retain the restriction. In addition, the unrestricted funds of the transferor charity may become restricted in the balance sheet of the transferee because the objects of the transferor charity were not exactly the same as those of the transferee charity. This issue can be addressed by:

- handling all transferred funds as restricted funds and using them for the purposes for which they were given, so they reduce over time
- changing the objects of the transferee charity so match the objects of both charities.

Changing the objects clause of a charity can take time, so it is often easier to accept the accounting treatment and ensure that expenditure is appropriately allocated to the funds.

Tax implications from merger

VAT

Transfers of assets

If both the transferor and transferee are not and have not been VAT registered, then the transfer will be outside the scope of VAT. However, if there are low levels of taxable activity in both entities, the merger may take taxable activity over the registration threshold and the merged charity will need to register for VAT.

- If one or the other is VAT registered and has recovered VAT on the transferring assets then there may be a deemed supply of the assets on which VAT is due. However, in many situations the transfer will qualify under the “transfer of a going concern” rules which take the transfer outside the scope of VAT. Risk areas include assets being transferred will not be used in the same kind of activity, property on which an option to tax has been exercised and where the transfer is to a member of a VAT group that has non-business or exempt activities.

If in doubt about the VAT status of a merger, then you should take professional advice.

Management charges and VAT

Post merger if there are to be two or more entities continuing, then management fees may be charged between the parties. These are subject to VAT if the charging charity is over the VAT registration threshold unless both charities form a VAT group.

Gift Aid

HMRC guidance states that where a charity changes its name (for example, because of a merger) the charity will not need to obtain a new Gift Aid declaration from a donor so long as the charity can show beyond doubt that the name of the charity on the existing declaration is a name previously used by the charity.

Where one charity is dissolved as part of a merger, it will need to make a final Gift Aid claim after all of the transfers of any regular donors has taken place.

If the new organisation is likely to be claiming through the Gift Aid Small Donations Scheme (GASDS) from 6 April 2013, there are a number of complex rules about inheriting a predecessor’s Gift Aid claim history. The new organisation would need this history to be able to claim under the GASDS and there are deadlines by which you have to register a claim to a predecessor body’s claim history. We suggest you seek professional advice on these deadlines.

Conclusion

There may be good reasons for charities to merge, for example:

- Two charities connected for a long time work closely together and can save overheads if they merge.
- Two similar charities can achieve economies of scale and improve levels of service delivery to their beneficiaries.
- A failing charity needs to be rescued by another in order to maintain services to beneficiaries.
- By merging, two campaigning charities will be able to raise their public profile and increase their influence for the good of their cause.

However, trustees must ask themselves:

- Is a merger in the best interests of our beneficiaries? Why?
- Is there a better way of achieving the desired end result?
- Can we really work effectively with the merger partner?
- What will key stakeholders such as beneficiaries, funders, employees and volunteers think and how will a merger affect those people?
- What will the costs of merger be and how do these compare with the expected savings?
- How much time and effort is this going to take? What is the impact of this on service delivery?
- Are there any risks with the merger partner?
- If member consent is required – how are we going to obtain this?
- What if it all goes wrong?

Trustees need to weigh both sides and regularly review their position.

Further information

CC 34: Collaborative working and mergers: An introduction

www.charitycommission.gov.uk/detailed-guidance/working-with-other-organisations/collaborative-working-and-mergers-an-introduction-cc34

Making mergers work: Helping you succeed

www.charitycommission.gov.uk/detailed-guidance/managing-your-charity/making-mergers-work-helping-you-succeed

Choosing to collaborate: How to succeed

www.charitycommission.gov.uk/detailed-guidance/working-with-other-organisations/choosing-to-collaborate-how-to-succeed/

A guide to people management when preparing and transferring services

[www.cipd.co.uk/binaries/5745%20TUPE%20guide%20\(WEB\).pdf](http://www.cipd.co.uk/binaries/5745%20TUPE%20guide%20(WEB).pdf)

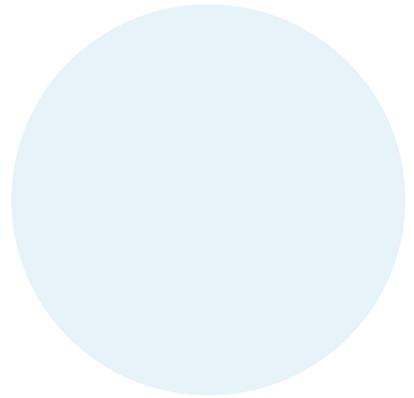
FRS102 – The Financial Reporting Standard applicable in the UK and Republic of Ireland

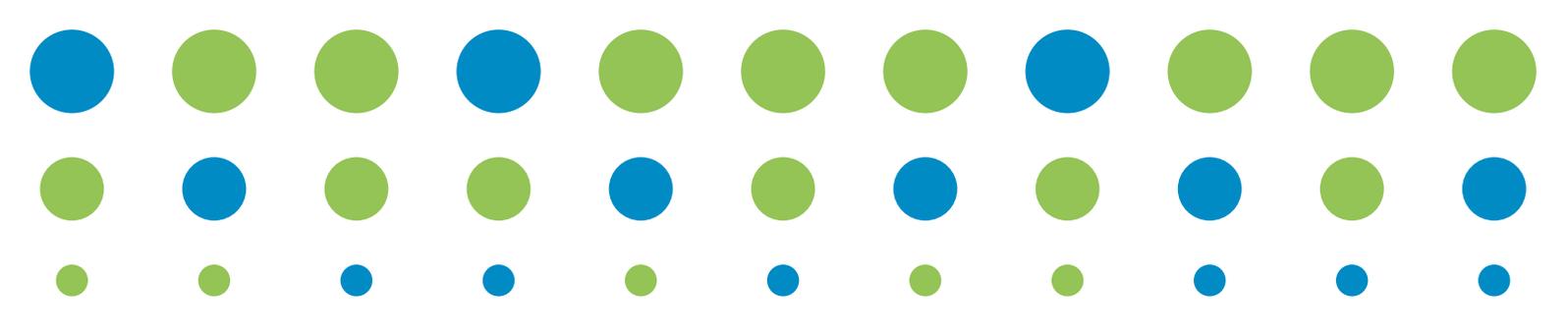
Section 19 and 34

Charities SORP (FRS102): Accounting and reporting by charities:

Statement of Recommended Practice applicable to charities preparing their accounts in accordance with the Financial Reporting Standard applicable in the UK and Republic of Ireland (FRS102) – effective 1 January 2015

Notes





Made simple guides

Made Simple guides are aimed at finance professionals and other managers working in charities. They cover technical areas such as tax and VAT treatments as well as information management areas and aim to provide practical guidance to busy managers and trustees in charities.



Made to measure

Sayer Vincent is a firm of chartered accountants working solely with charities and social enterprises. Through tailored audit and advice services, we provide trustees and managers with the assurance that their charity is managing its resources effectively.

As well as being commercial accountants, Sayer Vincent people have an in-depth knowledge of the governance and management of charities and social enterprises. We can advise on a range of business activities to achieve the best financial outcomes, keeping in mind the context of your organisation's objectives.

Working with Sayer Vincent, you will feel that you have extra people on your team.

For more information, go to www.sayervincent.co.uk



The content of guides is correct at the time of going to print, but inevitably legal changes, case law and new financial reporting standards will change. You are therefore advised to check any particular actions you plan to take with the appropriate authority before committing yourself. No responsibility is accepted by the authors for reliance placed on the content of this guide.