

made simple guides

Made Simple guides are aimed at finance professionals working in charities. They cover technical areas such as risk assessment, accounting, tax and VAT treatments and aim to provide practical guidance to busy accountants in charities.

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.

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sayer vincent
consultants and auditors

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CFDG (Charity Finance Directors' Group) is the professional body for finance directors within the sector, and has nearly 1,500 members. CFDG provides assistance to charities on a range of issues, such as accounting, taxation, audit and other finance-related functions. CFDG's mission is to deliver services that are valued by members and enable those with financial responsibility in the charity sector to develop and adopt best practice.

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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, 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 whether to go ahead.

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 parent and subsidiary route is best.

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.

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.

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.

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, that 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.

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

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 merger with a timetable and details of how 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.

In larger and more complicated mergers the key aspects of the agreement should be formally set out in a memorandum of understanding.

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?

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 manual and policies
- 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 response

Financial information

- Audited accounts, management accounts, budget and cashflow
- 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 forward
- Any consents necessary from regulators
- Attitude of funders, partners, beneficiaries and other stakeholders to the merger
- Any other factors which might materially affect merger prospects

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 transfer 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

Here all assets remain within the respective 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 (charity C) to become sole corporate trustee or member of both charities with charity C’s 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. However, this can be a time consuming and expensive approach and is usually best avoided unless absolutely necessary.

Employees and pensions

If employees are being transferred, the Transfer of Undertakings (Protection of Employment) regulations known as TUPE will almost certainly apply. 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.

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.

The Pensions Act 2004 now provides protection for transferring employees who were eligible to join an occupational pension scheme. The transferee will have to provide such employees with a minimum level of pension provision. They must match employee contributions up to 6% into a stakeholder scheme or offer an equivalent alternative.

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.

Charities Act 2006

The Charities Act 2006 contains a range of measures aimed at facilitating mergers.

Register of mergers

Only 'relevant mergers' can be registered. These are where one charity transfers all its assets to another charity then ceases to exist or two or more charities transfer all their assets to a new charity then cease to exist.

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.

Vesting declarations

The Act introduces a new mechanism for transferring assets – the vesting declaration. 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. If a vesting declaration is used the merger must be entered in the register of mergers.

VAT

If there is a transfer of ownership the main issue is whether the VAT incurred in merging is recoverable such as VAT on advisors' fees. This will depend on the VAT status of the activities being transferred and the current recovery rate of the charities concerned.

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.

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 merged
- Two similar charities can achieve economies of scale and improve levels of service delivery
- A failing charity needs to be rescued by another in order to maintain services
- By merging two campaigning charities will be able to raise their public profile and increase their influence.

However, trustees must ask themselves:

- Is merger really 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?
- What will be the costs of merger 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.

References and further information

CC 34: Collaborative working and mergers: an introduction
www.charity-commission.gov.uk/publications/cc34.asp

Policy statement on mergers, collaborative working and due diligence
www.charitycommission.gov.uk/enhancingcharities/merge.asp

Research report into charity mergers
www.charity-commission.gov.uk/publications/rs4.asp

**University of Liverpool Charity Law Unit:
Mergers – a legal good practice guide**
www.liv.ac.uk/law/clu/docs/mergersrep.pdf

**Aston University Centre for Voluntary Action Research:
Key findings on voluntary sector mergers**
www.abs.aston.ac.uk/newweb/research/cvar/forms/MergerKeyFindings.pdf

**NCVO publication:
Due diligence demystified (costs £15.00 / £10.50 NCVO Members)**
www.ncvo-vol.org.uk/publications/publication.asp?id=3715

NCVO Collaborative working micro-site
www.ncvo-vol.org.uk/collaborativeworking/index.asp?id=2038
A range of resources to support and encourage all forms of collaborative working

Baring Foundation/Bill Mather: Merging interests
www.baringfoundation.org.uk/merg_int.pdf