

# More Than Money

## Mergers & Acquisitions: The importance of conducting due diligence

There are more than 1.5 million nonprofit organizations in the United States, many of which have overlapping causes. Each year, more organizations compete for a finite pool of funding, resources and talent.

**T**here are many solid reasons for organizations to merge, including increasing funding opportunities, cutting costs and better achieving their mission.

This competitive pressure has been worsened by the economic downturn. There are fewer funding sources, and the funders may not want to give to multiple organizations with like causes.

For the past several years, mergers between nonprofit organizations – the process by which at least two nonprofit corporations join to form one legal entity – have been on the upswing.

There are many solid reasons for organizations to merge, including increasing funding opportunities, cutting costs and better achieving their mission.

Merging is a multi-step process. Due diligence is a critical step. If your organization merges with another nonprofit, it becomes owner of the other's funds, logo, name, assets, programs, licenses and other property. Your organization also takes on their debts, liabilities, contractual obligations and claims against them.

Due diligence may be costly and time consuming, but the risks of becoming a legal successor justify the intensive effort. Mergers should be a combination of strengths. Don't overlook the long-term impact of the merger in favor of immediate relief.

Distressed mergers often don't work, and many things can cause a merger to fail. Directors may be held personally liable if negative results occur because the organization didn't carefully examine the merger partner.

A robust diligence process can help protect directors from such challenges. Good due diligence reports will not only support the board's approval and recommendation for the merger, but will also serve as a type of "insurance policy" against personal liability of directors of both governing boards involved.

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## Helping board members understand your group's finances

Boards of directors come in all shapes and sizes. Some members are more knowledgeable about finances than others, but even the most financially savvy may not understand how the finances of a nonprofit work.

The finance director can help board members function more effectively by working with them to enhance their

understanding of the financial issues facing the organization.

Most people understand the concept of expenses – we all have them, after all. Expenses at a nonprofit don't differ significantly from expenses in other organizations.

Helping your board members understand the revenue equation is a good place to start. Most nonprofits depend on fundraising campaigns to generate much of their operating revenues. Board members are often expected to assist in this effort. However, many board members fail to understand how difficult fundraising can be or how critical it is to the success of the organization.

It is helpful for board members to see where contributions have historically come from. The finance director can easily share this

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## Mergers & acquisitions *from front*

Due diligence consists of legal due diligence conducted by attorneys and financial due diligence conducted by accountants.

In addition to reviewing the items in the box at right, you should interview the other organization's executive director, major donors, program directors and CFO. Be sure that no key stakeholders or funders are strongly opposed to the merger and staff are not resistant to change. Conduct background checks of key people.

Comparing financial information of the two organizations will help you identify items that can be eliminated or combined. The ones that can be combined should be split into those that can reduce costs and those that can increase revenue.

Compare the organizations' statements of financial position, budgets, donors, human resources and financial ratios. Prepare projections for a combined budget and a cost/savings analysis. Due diligence is more forward-looking than audits of historical financial statements.

Consider engaging an outside consultant or facilitator. The benefit of using external advisers is that the review is based on an independent viewpoint from a party with no direct interest in the outcome of the proposed transaction.

Seek advice from a tax attorney or tax accountant to assess whether the post-merger entity continues to be organized and operated for tax-exempt purposes. You should notify the IRS of the merger, and

submit copies of any amendments to your articles of organization or by-laws as part of the merger transaction. A new organization will need to receive determination that it is tax-exempt.

Tax-exempt organizations that end their operations must inform the IRS about the details of the action.

You may also wish to consider whether the merger will result in any adverse tax consequences, such as recognition of gains on assets transferred. If there is any concern about the tax consequences of a proposed merger, the parties may wish to first request a private letter ruling from the IRS.

Mergers are sophisticated transactions that are difficult to bring about on a do-it-yourself basis. As early in the process as practical, raise funds to cover the cost of the merger, including the cost of due diligence. Make sure there are people on your board who have experience with mergers. – *Mark E. Noble, CPA*



## Items to examine when conducting due diligence:

- ▲ Audits, tax returns and budgets for the last three to five years
- ▲ Current internal financial statements and budget
- ▲ Bank and investment statements, including a list of investments and investment policy and valuation method
- ▲ List of receivables and pledges receivable, including calculation of allowance for doubtful accounts
- ▲ Property and equipment – listing of assets and useful lives, title reports, inspections, capital needs assessment and reserves
- ▲ Liabilities – list of current recorded payables and accrued expenses (A search should also be made for unrecorded and contingent liabilities. Review payments made subsequent to the cutoff date, evaluating the adequacy of recorded accruals and inquiring with senior management.)
- ▲ List of any regulatory audits and their outcome in the past three years, including any outstanding issues
- ▲ List of limitations on the use of any funds, including temporary or permanent restrictions (Understand these limitations because the restrictions survive the merger.)
- ▲ Listing of leases, grants to pay others and any other commitments
- ▲ Listing of insurance coverage in place
- ▲ List of loans outstanding
- ▲ List of past legal judgments
- ▲ Articles of incorporation, bylaws and IRS determination letter
- ▲ Development – list of donors, noting donors that are new or those that overlap
- ▲ Information systems, including development software (You should plan on merging the donor databases.)
- ▲ Board and executive committee meeting minutes for the past 12 months
- ▲ Copies of licenses and permits
- ▲ Personnel:
  1. List of active employees and pay
  2. Performance evaluation criteria and bonus plans
  3. Copy of any collective bargaining agreements
  4. Copy of pension plans, including retirement and health plans
  5. Vacation/PTO policies
  6. Employee handbook
  7. Employee contracts
  8. History of workers' compensation claims, and verification of misclassified workers
  9. Employee vs. independent contractor issues
  10. Employee discipline records
  11. Deferred compensation agreements

## New accounting rules for mergers and acquisitions

If you are considering combining your organization with another nonprofit, you need to be familiar with new rules for business combinations.

The key step in complying with the new rules – Accounting Standards Codification 958-805 that became effective for business combinations after Dec. 15, 2009 – is to determine if the combination is a merger or an acquisition.

A merger occurs when the boards of two or more nonprofit organizations cede control to create a new entity. The governing board of the new entity must be newly formed, but forming a new legal entity is not a requirement.

An acquisition is the result of a nonprofit organization obtaining control of one or more not-for-profit activities or businesses.

### Accounting for Mergers

Mergers are accounted for using the carryover method, which is similar to the pooling-of-interest approach. You simply add together the historical financial data of the merging entities as of the merger date.

However, under the new rules, a new entity starts at the merger date for accounting purposes. Financial statements of the period of the merger include only data since the merger date.

Since the successor organization is a new entity after a merger, there is no prior period statement of activity or cash flows. Under the old method, the measurement date was the beginning of the reporting period, treating it as a continuation of the merged-in entities.

### Accounting for Acquisitions

If a combination does not qualify as a merger, then acquisition accounting will be used.

If acquisition accounting is required, the organizations will have to identify which entity is the acquirer, determine the acquisition date, and recognize identifiable tangible and intangible assets acquired, liabilities assumed, and goodwill or a contribution received.

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# How to account for corrections in net asset balances

Not-for-profit entities sometimes need to make corrections to prior-year financial statements so that net assets are appropriately classified in financial statements.

There has been some inconsistency in practice in addressing the circumstance where changes in classifications within net assets in the prior period need to be made.

Prior-period statements are often presented for comparative purposes with current-year financial statements. The apparent confusion relates to whether the changes within net assets should be considered by focusing on net assets in the aggregate or by individual net asset class.

Depending on how not-for-profit entities have addressed this particular issue, financial statements sometimes have reflected the net asset changes as being error corrections and, in other circumstances, the statements have reflected the changes simply as being reclassifications.



To clarify how this financial reporting issue needs to be addressed, the AICPA released some Technical Practice Aid guidance that can be found in TIS Section 6140.23, *Changing Net Asset Classifications Reported in a Prior Year*.

The Technical Practice Aid guidance refers to the authoritative literature in reaching the conclusion that the appropriate approach in evaluating this particular circumstance would be to focus on individual net asset classes, rather than net assets in the aggregate.

As a reminder, pursuant to the guidance in the FASB Accounting Standards Codification (FASB ASC) Topic 250, *Accounting Changes and Error Corrections*, errors in previously issued financial statements include those related to measurement, presentation or disclosure in the financial statements resulting from mathematical errors, mistakes in the application of accounting principles generally accepted in the United States (U.S. GAAP), or oversight or misuse of facts that existed at the time the financial statements were prepared.

Additionally, a change from an accounting principle that is not considered to be generally accepted to one that is generally accepted would be considered an error correction.

Not-for-profit entities need to consider individual net asset classes rather than net assets in the aggregate when determining whether correction of classifications in previously issued statements constitute errors in those statements.

The pertinent guidance here actually falls within FASB ASC 958, *Not-for-Profit Entities*. That guidance contains the clear stipulation that usefulness of information provided in the financial statements is improved significantly if certain basic financial information is classified in a comparable manner from period to period.

In developing the authoritative accounting guidance that addresses this particular financial reporting issue, the FASB concluded that, in assessing the financial position or performance of not-for-profit entities, it is important to avoid focusing attention almost exclusively on net assets, the change in net assets, total assets or other highly simplified and aggregated amounts.

As an example, using the guidance in FASB Concepts Statement No. 6, *Elements of Financial Statements*, since donor-imposed restrictions affect the types and level of service not-for-profit entities can provide when the entities have maintained certain classes of assets may be more significant than whether they have maintained net assets in the aggregate.

Reclassification of net assets – i.e., simultaneously increasing one net asset class and decreasing another asset class – needs to be made when any of the following circumstances exist:

- ✦ Not-for-profit entities fulfill purposes for which net assets were restricted.
- ✦ Donor-imposed restrictions expire with the passage of time or with the death of a split-interest agreement beneficiary, if the net assets are not otherwise restricted.
- ✦ Donors withdraw, or court actions remove, previously imposed restrictions.
- ✦ Donors impose restrictions on otherwise unrestricted net assets.

To illustrate the last item, donors may make restricted contributions that are conditioned on not-for-profit entities restricting stated amounts of unrestricted net assets. Restrictions that are not reversible without consent of donors result in reclassification of unrestricted net assets to restricted net assets.

Essentially, it is important for not-for-profit entities to carefully evaluate classifications within individual net asset classes in efforts to avoid having to correct prior-period financial statements that are presented for comparative purposes.

While many circumstances exist for which reclassifications between net asset classes would be appropriate, any restatements due to inappropriate classifications within net asset classes would not be reflected as reclassifications in the financial statements. Rather, those types of situations result in error corrections being reflected in the statements. – *Thomas A. Ratcliffe, Ph.D., CPA*

## New accounting rules *continued from other page*

The acquisition method requires all assets acquired and liabilities assumed to be recognized at fair value as of the acquisition date. A valuation expert may need to be engaged to assist in identifying and valuing intangible assets.

If consideration is transferred, goodwill can be recognized if the consideration is in excess of the fair value of net assets acquired. An acquirer that expects the acquired organization as part of the combined entity to operate like a business – for instance, charging fees to cover costs – must recognize goodwill as an asset at the acquisition date.

An acquirer that expects the operations of the acquired organization, as part of the combined entity, to be predominantly supported by contributions and returns on investments

is required to recognize as a separate charge in its statement of activities the amount that otherwise would be recognized as a goodwill asset at the acquisition date.

If no consideration is exchanged, then the acquirer recognizes an inherent contribution received for the fair value of assets acquired in excess of liabilities assumed. If a deficit is absorbed with no consideration transferred, then the acquirer follows the goodwill approach mentioned above. All costs of acquisition are expensed as period costs.

There are differing forms of combinations, collaborations and alliances between nonprofit organizations. Organizations should seek legal counsel to help with structuring “the deal.” – *Mark E. Noble, CPA*



## Helping board members *continued from front*

information. A pie chart or bar graph is an easy way to illustrate the significance of different types of contributions.

In many nonprofit organizations, individual or family contributions make up the bulk of revenues, which is surprising to many board members. These often come in small contributions throughout the course of the year and are often tied to specific events, mailings or promotions.

Corporate gifts supplement the money raised from grassroots campaigns and generally come in larger, less frequent amounts, though the recent economic climate has resulted in reductions in corporate giving.

In-kind donations are also important and should be broken out separately, since these gifts don't translate into cash to cover operating expenses. Grants and government funding should also be shown.

Seeing the revenue equation and the changes caused by the economic downturn can help board members understand the importance of their role as fundraising advocates.

The expense side of the equation also comes into play. An efficiently run and fiscally sound organization can inspire trust and attract more donations. Donors often want to know how much of their contributions actually go to the

mission of the organization as opposed to administrative costs. The finance director should have solid information on this question to share with the board and the public, along with how the organization compares to others in the area.

Focusing only on numbers and spreadsheets, which finance directors sometimes do, often causes board members to glaze over, especially those who are less financially oriented. The real story is about the people who contribute, and board members of all types will relate to these stories.

The finance director and development director can work together to share the stories behind the numbers. What inspires donors to give? What types of people contribute most often? How did those people learn about the organization? What role does the board play in getting the grassroots contributions in the door? And, perhaps most critically, what happens if those funds don't come in?

For those working in a nonprofit organization, it is sometimes easy to forget that you operate in a world different from the for-profit sector. You may assume that board members understand things they don't. Don't assume. Use the numbers to tell the story that is critical to the success of your organization. – *Denise Altman, CPA, M.B.A.*

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The technical information in this newsletter is necessarily brief. No final conclusion on these topics should be drawn without further review and consultation. Please be advised that, based on current IRS rules and standards, the information contained herein is not intended to be used, nor can it be used, for the avoidance of any tax penalty assessed by the IRS.

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