Presenters

Lee Klumpp, CPA, CGMA
National Assurance, Director Nonprofit & Education
BDO USA, LLP
(703) 336-1497
lklumpp@bdo.com

Jeffrey J. Schragg, CPA, JD
Tax Partner
BDO USA, LLP
(703) 770-6313
jschragg@bdo.com

Kirk L. Brett, Esq
Partner
Duval & Stachenfeld LLP
(212) 692-5525
kbrett@dsslpp.com

Ritesh Lall, CPA, CGMA
Director - Assurance Services
BDO USA, LLP
(212) 885-7337
rlall@bdo.com
Agenda

Today, we will discuss the following

• The difference between a merger or acquisition,
• The legal process and complexities of a merger or acquisition, by Nonprofits and/or with a for-profit entity,
• Some effective transaction strategies and structures that can be used in these types of transactions,
• Key accounting and tax considerations, and
• Best Practices
Legal Structure
First Things First

► Confirm Current Legal Structures
  ▪ Exempt Entities
  ▪ Non-Exempt Entities

► It’s a “Multi-Species” World

► Memorandum of Understanding (or LOI)
Common Reasons for Merger or Acquisition

Lower Administrative Expenses
Consolidate Donor Pool
Increase Impact on Mission
Address Leadership Changes
Financial Distress
Primary Methods/Structure

Merger of Equals
Merger of Un-equals
Acquisition: Sole Membership
Steps Involved in Merger

Identify Merger Partner
Negotiate Terms/Documents
Board Approvals
Sign Agreement (With New By-Laws)
Approval of State Regulator
Consummate Merger
Identifying Merger Partner

Discuss Goals/Mission of Each Partner
Identify Benefits/Drawbacks of a Merger
Determine Compatibility of Board Members
Determine Impact on Donors/Other Stakeholders
Negotiation

Board Designee/Subcommittee to Negotiate Terms
Governance Terms: Board Composition; Chairman; Executive Director
Name of the Organization
Pending Projects
Term Sheet
Governance Terms

Big Picture for Term Sheet:

- One Large/Consolidated Board
- Two Classes of Board Members

Additional Terms Left for Later - By-Laws
Merger Agreement / Plan of Merger

Implement the Term Sheet
Provide for New By-Laws
Identify Initial Directors/Officers
Pre-Consummation Operations
Brand/Corporate Name
Representations and Warranties
No Real Remedy For Breach Post-Closing
Funding Operations Pre-Merger
Conditions to Merger
By-Laws

Implement Term Sheet as to Big Picture Governance Provisions
Additional Governance Items
Sunset Term on Separate Appointments
Term of Each Board Member
Board Officers: Chairman, etc.
Executive Committee
Other Committees
Removal of Board Member
Replacement of Board Member
Corporate Officers
Approvals

Board of Each Entity
Attorney General or Court
- May Take Months
- Mission of Each Entity
- Financial Condition
- Use of Restricted Assets
- Effect on Public (i.e., health care)
Pre-Closing Operations

Ordinary Course
Significant or New Projects
Transition Planning
Consummation

Following Approval of Attorney General/Court Certificate of Merger
Post-Closing Governance

Governed by New By-Laws
Potential Disappointment in Merger of Un-Equals
Overview of Acquisition

Acquirer Becomes Sole Member of Target
Sole Member Appoints The Board
No Attorney General/Court Approval
Target Liabilities Remain With Target
Tax Considerations
Tax Due Diligence

► Income tax
  ▪ Forms 1023 and 1024
  ▪ Determination Letters
  ▪ Forms 990, 990-T and States

► Other Taxes
  ▪ Sales
  ▪ Property
  ▪ Payroll (Worker Classification)
  ▪ Excise

► State Solicitation Compliance
Structuring

- Affiliation Agreement
- Joint Operating Agreement
- Merger
- Asset Purchase
- New Holding Company
- Dissolution
Post Transition

- Reporting to IRS
- Final Returns
- Updating IRC §509 Classifications
- Employee Integration
  - 401(k)
  - 457
  - 403(b)
  - Salary levels
  - Healthcare
- Right-sizing Operations
Traps for the Unwary

- Section 337(d)(2)
- Supporting Organization Updates
- IRS Exams Post Transition
- Section 457
Not-for-Profit Entities: Mergers and Acquisitions

- How it compares to Statement of Financial Accounting Standards No. 141(R), (ASC 805), Business Combinations (SFAS141 (R)):
  - Similarities (The Acquisition Method)
  - Differences (Recognition of Goodwill)

- Two types of not-for-profit entities
  - Those that are solely or predominately supported by contributions and returns on investments
  - Those the receive support from fees for services (more “businesslike”)

http://nonprofitblog.bdo.com
@BDONonprofit
Accounting Considerations
Accounting for combinations of not-for-profit organizations:

- Statement of Financial Accounting Standard (SFAS) No. 164 (ASC 958-805) (SFAS No. 164), *Not-for-Profit Entities: Mergers and Acquisitions* distinguishes the difference between a merger or an acquisition.

- Key Concepts:
  - Mergers are accounted for on ‘carryover basis’ - similar to pooling accounting under Accounting Principles Board (APB) Opinion 16 *Business Combinations*, (ASC 958-805) (APB 16).
  - Acquisitions accounted for on ‘acquisition basis’ - similar to SFAS 141(R).
  - Determining factor of a merger: *ceding of control* by the governing bodies of two (or more) organizations to a new organization; the governing board of the new entity must be newly formed, but establishing a new legal entity is not a requirement.
  - Other factors such as relative size, relative dominance of the process and of the combined entity, and relative financial health, can be considered in judging whether control has been ceded, but are not themselves determinants of a merger vs. an acquisition.
  - All other combinations are acquisitions.
Accounting for a merger

- For mergers we now use the carryover basis of accounting, which adds together the historical financial data of the merging entities as of the merger date (not, as under APB 16, as of the beginning of the fiscal year in which the merger occurs).

- Financial statements of the period of the merger include data only since the date of the merger (except that for a public company (FASB Staff Position (FSP) No. 126-1, (ASC 825), Applicability of Certain Disclosure and Interim Reporting Requirements for Obligors for Conduit Debt Securities), pro forma disclosure is required as if the merger had occurred at the beginning of the fiscal year).

- Conform accounting policies, except, because this is not a ‘fresh-start’, a merger is not an event that permits the election of accounting options that are restricted to the entity’s initial acquisition or recognition of an item (or the reversal of a previous election). Thus, for example, one merging entity’s election of the fair value option (Statement of Financial Accounting Standards No. 159, (ASC 825) The Fair Value Option for Financial Assets and Financial Liabilities—including an amendment of FASB Statement No. 115), for a particular financial asset or liability permits neither the new entity’s election of the fair value option for other financial assets or liabilities nor reversal of a previous election of this option.
Accounting for a merger (Cont’d)

- Eliminate effects of any intra-entity transactions.
- All reclassifications, adjustments, and other changes needed to effect a merger are rolled into opening balances.
- Since the successor organization after a merger is a new entity, there is no prior period statement of activity or cash flows (an ‘opening’ balance sheet may be presented if desired).
Accounting for an acquisition

- Identifiable assets and liabilities (and any noncontrolling interest) of the acquired entity are brought in at their fair values at date of acquisition.
  - Exceptions specific to nonprofits: Collections are accounted for in accordance with the policy of the acquirer; conditional pledges are not recorded; no value is attributed to donor relationships.
  - Exception for leases: Leases are classified (operating vs. capital) according to their terms at lease inception, unless they have been modified.

- If the value of the acquired assets exceeds the sum of the acquired liabilities plus any consideration, the difference is recorded as an inherent contribution and reported as a separate credit in the statement of activities

- If the sum of the liabilities plus consideration exceeds the assets, the difference is recorded as goodwill, except:
  - if the entity is predominantly supported by contributions and/or investment return, the goodwill is written off immediately as a separate charge in the statement of activities (‘predominantly supported by’ means that contributions and investment return are expected to be significantly more than the total of all other revenues)

Accounting for an acquisition (Cont’d)

➢ Acquisition-related costs are period expenses, except for debt issuance costs.

➢ Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets (ASC 350) (SFAS 142) is made fully effective for not-for-profit entities (goodwill is no longer amortized, rather it is tested for impairment).

   Exception: SFAS 142 does not apply to:
   a. The formation of a joint venture
   b. The acquisition of assets that do not constitute either a business or a nonprofit activity
   c. A combination between entities under common control
   d. An event in which a not-for-profit entity obtains control of another entity but does not consolidate that entity, as permitted or required by AICPA SOP No. 94-3.

➢ Various descriptive, quantitative, and qualitative (why the merger/acquisition occurred) disclosures are required.
Fair Value Accounting Considerations
Fair Value Usage

The consideration transferred in an acquisition by a not-for-profit entity shall be measured at fair value, which shall be calculated as the sum of the acquisition-date fair values of the assets transferred by the acquirer and the liabilities incurred by the acquirer.

The acquirer shall measure the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at their acquisition-date fair values.

Fair Value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (paragraph 5 of FASB Statement No. 157 (ASC 820), Fair Value Measurements).

Market participants are buyers and sellers in the principal (or most advantageous) market for the asset or liability that are:

a. Independent of the reporting entity; that is, they are not related parties.
b. Knowledgeable, having a reasonable understanding about the asset or liability and the transaction based on all available information, including information that might be obtained through due diligence efforts that are usual and customary.
c. Able to transact for the asset or liability.
d. Willing to transact for the asset or liability; that is, they are motivated but not forced or otherwise compelled to do so.
Fair Value of Consideration

- Acquisition date is the date effective control is achieved
- If the initial accounting for an acquisition is incomplete by the end of the reporting period, the acquire reports provisional amounts. The acquirer will retrospectively adjust amounts until the acquirer receives information it was seeking about facts and circumstances that existed as of the acquisition date or learns the information is unobtainable, but in no cases shall this exceed one year. This is the measurement period.
- Contingent consideration is recognized at fair value as part of acquisition consideration
- Acquisition related costs are expensed
- Preexisting Relationship between the Acquirer and the Acquiree that effectively settled, it is measured at:
  a. For a preexisting noncontractual relationship (such as a lawsuit), fair value
  b. For a preexisting contractual relationship, the lesser of:
    1) The amount by which the contract is favorable or unfavorable from the perspective of the acquirer when compared with pricing for current market transactions for the same or similar items. (An unfavorable contract is a contract that is unfavorable in terms of current market terms. It is not necessarily a loss contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.)
    2) (2) The amount of any stated settlement provisions in the contract available to the counterparty to whom the contract is unfavorable.

If (2) is less than (1), the difference is included as part of the acquisition accounting.
What is Goodwill?

An asset representing the future economic benefits arising from other assets acquired in a business combination or an acquisition by a not-for-profit entity that are not individually identified and separately recognized [Paragraph 3(j) of Statement 141(R)].
Identifying Intangible Assets and Goodwill

➢ The acquirer shall recognize separately from goodwill the identifiable intangible assets acquired. The asset is identifiable if:

• Is separable, that is, capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability, regardless of whether the entity intends to do so; or

• Arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations (paragraph 3(k) of SFAS 141(R)).

➢ Exceptions:

• Donor Relationships
• Collections
• Conditional promises to give
• Assembled and trained workforce
Identifying Intangible Assets and Goodwill

Goodwill is measured as the excess of (a) over (b) below:

a. The aggregate of:
   - The consideration transferred measured at its acquisition-date fair value
   - The fair value of any noncontrolling interest in the acquiree
   - In an acquisition achieved in stages, the acquisition-date fair value of the acquirer’s previously held equity interest in the acquiree.

b. The net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with this Statement.
Identifiable Intangible Assets

Marketing Related:
- Trademarks, trade names, service marks, collective marks, certification marks
- Trade dress (unique color, shape, package design)
- Newspaper mastheads
- Internet domain names
- Noncompetition agreements

Artistic Related
- Plays, operas, ballets
- Books, magazines, newspapers, other literary works
- Musical works such as compositions, song lyrics, advertising jingles
- Pictures, photographs
- Video and audiovisual material, including motion pictures or films, music videos, television programs.

Customer and Donor Related
- Donor lists
- Order or Production Backlog
- Customer contract and related customer relationships
- Non-contractual customer relationships

Contract-Based
- Licensing, royalty, standstill agreements
- Advertising, construction, management, service or supply contracts
- Lease agreements (whether the acquiree is the lessee or the lessor)
- Construction permits
- Franchise agreements
- Operating and broadcast rights
- Employment contracts
- Use rights such as drilling, water, air, timber cutting, and route authorities.

Technology Based
- Patented technology
- Computer software and mask works
- Unpatented technology
- Databases, including title plants
- Trade secrets, such as secret formulas, processes, recipes.
Items to Support in Fair Value Determination

- Controls over the process used to determine fair value measurements, including, for example, controls over data and the segregation of duties between those committing the entity to the underlying transactions and those responsible for undertaking the valuations.
- The expertise and experience of those persons determining the fair value measurements.
- The role that information technology has in the process.
- The types of accounts or transactions requiring fair value measurements or disclosures (for example, whether the accounts arise from the recording of routine and recurring transactions or whether they arise from nonroutine or unusual transactions).
- The extent to which the entity’s process relies on a service organization to provide fair value measurements or the data that supports the measurement. When an entity uses a service organization, the auditor considers the requirements of SAS No. 70, Service Organizations (AICPA, Professional Standards, vol. 1, AU sec. 324), as amended.
- The extent to which the entity engages or employs specialists in determining fair value measurements and disclosures.
- The significant management assumptions used in determining fair value.
- The documentation supporting management’s assumptions.
- The process used to develop and apply management assumptions, including whether management used available market information to develop the assumptions.
- The process used to monitor changes in management’s assumptions.
- The integrity of change controls and security procedures for valuation models and relevant information systems, including approval processes.
- The controls over the consistency, timeliness, and reliability of the data used in valuation models.
Valuation Process

Due Diligence
- Gather Relevant Company Data
- Interview Key Management
- Research Industry and Economic Factors
- Search Databases for Market Data

Analysis
- Analyze Financial Performance and Forecasts
- Determine Appropriate Valuation Method(s)
- Prepare Models and Supporting Schedules

Prepare Report
- Summarize Facts
- Describe Assumptions and Analysis
- Outline Methodology Selection and Application
- Describe Conclusion
Goodwill Acquired

- Recognized as goodwill as of the acquisition date if the combined entity is supported by resources other than contributions and returns on investments.
- Measured as the excess of (a) over (b):
  a) the aggregate of:
     1) the consideration transferred measured at its acquisition-date fair value;
     2) the fair value of any non-controlling interest in the acquiree; and
     3) in an acquisition achieved in stages, the acquisition-date fair value of the acquirer’s previously held equity interest in the acquiree.
  b) The net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed.
- However, if the combined entity is predominately supported by contributions and return on investments, the excess of (a) over (b) is recognized as a separate charge in the statement of activities as of the acquisition date rather than as goodwill.
Goodwill Acquired (cont’d)

- Consider all relevant qualitative and quantitative factors in determining the expected nature of the predominant source of support.

- If no consideration is transferred, the goodwill or the separate charge would be the excess of liabilities assumed over assets acquired.
Transition for Previously Recognized Goodwill

- For combined entities predominately supported by contributions and returns on investments, write off previously recognized goodwill by a separate charge in the statement of activities at the acquisition date.

- For combined entities not predominately supported by contributions and returns on investments: 1) establish the reporting units [Paragraph 54 of Statement 142] and 2) perform a transitional goodwill impairment evaluation [Paragraphs 55-58 of Statement 142].
Goodwill and Other Intangible Assets

SFAS No. 142 has been amended to apply to not-for-profit entities for goodwill and other intangible assets acquired in an acquisition by a not-for-profit entity.
What is meant by “Predominately Supported”?

SFAS 164 defines “predominately supported” to mean that contributions and returns on investments are expected to be significantly more than the total of all other sources of revenue.
What is a Contribution?

Statement of Financial Accounting Standards No. 116, (ASC 605) (SFAS 116) Accounting for Contributions Received and Contributions Made defines a contribution as an unconditional transfer of cash or other assets to an entity or a settlement or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner.

An inherent contribution is made if an entity voluntarily transfers assets (or net assets) or performs services for another entity in exchange either for no assets or for assets of substantially lower value and unstated rights or privileges of a commensurate value are not involved.
Contribution Received

- Recognize as a separate credit in the statement of activities as of the acquisition date.
- Measured as the excess of (b) over (a):
  
  (a) the aggregate of:
   
   (1) the consideration transferred measured at its acquisition-date fair value;
   (2) the fair value of any non-controlling interest in the acquiree; and
   (3) in an acquisition achieved in stages, the acquisition-date fair value of the
   acquirer’s previously held equity interest in the acquiree.

  (b) The net of the acquisition-date amounts of the identifiable assets acquired
and the liabilities assumed.

- If no consideration is transferred, the excess amount would be the excess of assets
acquired over liabilities assumed.
Consideration Transferred

- In acquisitions by not-for-profit entities
  - Measured at the acquisition-date fair value.
  - The sum of the assets transferred and the liabilities incurred.

- Forms:
  - Cash.
  - Other assets.
  - A business or a nonprofit activity of the acquirer.
  - Contingent consideration.
Accounting Guidance
Relevant Guidance


FASB Staff Position (FSP) No. SFAS 126-1 (ASC 825): *Applicability of Certain Disclosure and Interim Reporting Requirements for Obligors for Conduit Debt Securities*


Questions