



Avoiding pitfalls in business combinations

Determining if a not-for-profit combination qualifies for merger accounting



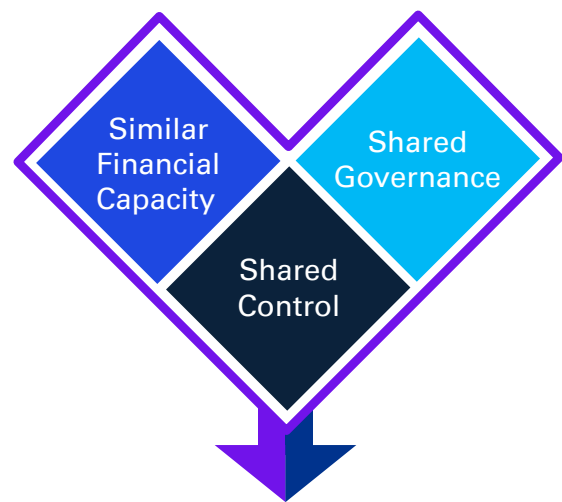
Accounting Standards Codification (ASC) Subtopic 958-805, *Not-for-Profit Entities – Business Combinations*, provides guidance on accounting by not-for-profit entities (NFP) for a combination with one or more other NFPs or businesses. Under ASC Subtopic 958-805, a NFP applies either (1) the carryover method to account for a merger, or (2) the acquisition method to account for an acquisition.

This document provides a brief overview of the factors to consider when determining if a combination should be accounted for as a merger or as an acquisition.

Assessing if control has been ceded to a new NFP entity

ASC paragraph 958-805-55-1 states that ceding control by the prior NFP to a new NFP is the sole criteria for determining that a combination is a merger. In contrast, a combination is an acquisition when one NFP obtains control over the other. If the participating entities in a combination retain shared control of the NFP, they have not ceded control.

To qualify as a new NFP, the newly established combined NFP must have a newly formed governing body and is often, but not required to be, a new legal entity. ASC paragraphs 958-805-55-3 through 55-8 include additional considerations for purposes of evaluating whether a combination is a merger or an acquisition and focuses on areas such as the process leading to the combination, the participants to the combination and the combined entity. In particular, one needs to evaluate and consider the governance, related control powers, and financial capacity of the entities in the combination.



Merger Accounting Treatment

Evaluating governance and related control powers

When assessing the impact of governance and control on the accounting treatment for the combination, it may be helpful to ask the following questions:

- Have the governing bodies of the entities participating in the combination ceded control and what was the process leading up to the combination and the formation of the combined entity? Did one of the participating entities dominate the process or were decisions reached on a mutual basis? *One entity dominating the negotiations tends to be an indicator of an acquisition, whereas a situation where no one party dominates or is capable of dominating the negotiations and process leading to the formation of the combined entity tends to be an indicator of a merger.*
- Can one entity appoint significantly more of the governing board to the newly formed entity? *If so, this may be more indicative of an acquisition than a merger.*

- Does the newly formed entity derive its senior officials, bylaws, operating policies, and/or practices from the participating entities or are they sourced more heavily from one of the participating entities? *A mix from both participating entities may indicate a merger as opposed to an acquisition.*

Evaluating financial factors

Financial strength and size, among other financial factors, are also important to consider when determining whether the combination is a merger or an acquisition. It may be helpful to ask the following questions:

- What financial contributions are being made by the participating entities to the combination? *One entity making significantly more contributions than another may be indicative of an acquisition over a merger. Conversely, a merger generally is accomplished by combining all of the assets and liabilities of the merging entities into a newly formed entity.*
- What is the financial strength and size of each of the participating entities? *Is one of the participating entities experiencing financial difficulties and will it depend on the other entity to provide back-office and information technology support for a below-cost fee? If one entity is financially stronger and larger in size, that entity may be able to dominate the negotiations of the transaction, which would be more indicative of an acquisition than a merger. To gauge the relative financial strength of the participating entities, one can look at the credit ratings of the entities involved in the combination as part of the process.*

It is also important to consider the following points when determining if a merger has occurred:

- Unlike the formation of a joint venture arrangement in which the participating entities continue to exist and usually hold a financial interest, the creators of the merged entity cease to exist as autonomous entities and neither holds a financial interest in the merged entity.

- The merged entity generally has a perpetual life rather than a life that is limited by the period of the venture or that allows for one or more of the participating entities to opt out of the venture or other arrangement.

Other considerations

In accordance with ASC paragraph 958-805-55-2, the participating NFP must make a decision based on the *preponderance of the evidence* about whether each of the governing bodies have ceded control to create a new NFP, whether one entity has acquired the other, or whether another form of combination, such as the formation of a joint venture, has occurred.

ASC paragraphs 958-805-55-9 through 55-31 provide illustrative examples for assessing whether a combination is a merger, an acquisition, or is neither a merger nor an acquisition.

All of the indicators and illustrative examples should be carefully considered based on the actual facts and circumstances in determining whether the combination is a merger or an acquisition.

It is advisable to involve a subject matter professional early in the process to assist company management in evaluating the likely accounting implications for combinations by a NFP.

Have questions?

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