

Checklist for due diligence



What is due diligence?

'Due diligence' is a phrase with its origins in the corporate sector. It is used to describe the steps organisations take to assure themselves that a merger is in their best interests. In charities, 'due diligence' describes the examination of another charity or charities in advance of completion of a merger. The result of a due diligence exercise is that a charity has full knowledge of the organisation they seek to merge with (ie there are no surprises).

The costs of commissioning due diligence work are a proper use of charitable funds, but should be forecast at the outset and regularly reviewed to ensure they remain proportionate to the risks involved.

Due diligence checks fall into three main categories:

- commercial
- financial
- legal

The nature of the checks should be proportionate to the:

- size and nature of the proposal;
- amount of income and expenditure involved; and
- nature of the existing and planned activities.

For example, a more rigorous exercise may be necessary where charities have one or more of the following:

- complex service delivery arrangements
- high profile or sensitive work
- links with affiliated charities
- operations in a number of geographical locations
- one or more trading subsidiaries
- extensive property holdings and assets
- restricted funds or permanent endowments

Trustees' role

Trustees are responsible for deciding on the appropriate level of due diligence required when considering a merger with another charity(s). They have a legal duty to act prudently. When planning a proposed merger or contractual collaborative arrangement, they should ensure they have identified any potential risks to their charity before entering into any agreement.

Depending on their initial assessment, trustees may require professional advice to ensure that there is an appropriate level of due diligence.

About the checklist

The following checklist is a guide to the areas to review in a due diligence exercise. It is intended to be of use to trustees in understanding the due diligence exercise.

Commercial due diligence checklist

Area to review	What to do	How to use this information/Questions to ask
Reasons for merging	Review appropriate board minutes and identify the benefits of the merger for the beneficiaries.	What are the reasons for merging? What benefit will merging bring to beneficiaries?
Charitable objects	Review charitable objects.	Are the charitable objects compatible?
Fundraising strategy	Review amount raised in the last two years and compare with budget.	Is the effectiveness of the fundraising strategy reviewed against a predetermined programme?
Donors and funders	Consult with existing donors and funders about merger. Review other sources of finance and support.	Will they continue to support the proposed merged charity?
Beneficiaries	Review existing and potential beneficiaries.	In the long term, as a result of the merger, will the number of beneficiaries increase?
Trustees and management	Review CVs and contracts of employment for chief executives and senior management. Get CVs of trustees. Compare current provision with future need.	Is there sufficient trustee/management experience in different disciplines for the merged charity?
Organisational structure	Review organisation charts and staff handbooks.	Are the organisational structures of the charities compatible?
Governance	Review current governance mechanisms.	What interim/future governance mechanisms will be required?
Effectiveness of board meetings	Review minutes of board meetings. Review minutes relating to financial information.	Are there recurring issues in board minutes which indicate an issue that is not being properly addressed? Are minutes and papers well presented especially regarding financial information? Are management accounts providing relevant and necessary information available for trustees and operating managers?
Risk management	Review risk register and appropriate board minutes.	Are there significant risks that need to be resolved before merging?
Information technology	Review information technology systems.	Are systems compatible? How might existing IT systems be used in the merged charity? Is there scope to consolidate?
Stakeholders opinion	Consult with stakeholders about merger.	Will they continue to support the proposed merged charity?
Competitive position	Identify charities with similar objectives.	Will these charities prove to be too competitive and prevent the merged charities from achieving their objectives?
SWOT analysis	Review any existing SWOT analysis or conduct a SWOT analysis.	What issues does this raise?

Financial

a) Accounts

Area to review	What to do	How to use this information/Questions to ask
Annual financial statements	<p>Identify the main sources of income and categories of expenditure for the last 2/3 years.</p> <p>Review the excess of assets over liabilities for the last 2/3 years.</p>	<p>What are the trends for the last 2/3 years of excess income over expenditure and excess assets over liabilities?</p> <p>This will confirm the charity's solvency.</p>
Management accounts	<p>Compare</p> <ul style="list-style-type: none"> - accuracy of year end management accounts with annual financial statements for that year. - management accounts with budget or latest forecast. - management accounts and annual financial statements for previous 2 years with budget/forecast for following 2 years. 	<p>Are periodic management accounts reliable for decision making?</p> <p>Is current budgeting/forecasting reliable and realistic?</p> <p>What are the reasons for any variances which have arisen?</p>
Cash flow	<p>Review cash flow and look for trends that show sustainability.</p>	<p>Are there any potential deficits that need to be monitored arising from timing differences in future cash flow?</p>
Accounting standards	<p>Confirm compliance with the Statement of Recommended Practice, Accounting and Reporting (SORP) for charities, Standard Statements of Accounting Practice (SSAP) and Financial Reporting Standards (FRS).</p>	<p>Are there any departures from the SORP, SSAPs and FRSs?</p>
Accounting policies and internal financial controls	<p>Compare accounting policies and internal financial controls with your own.</p>	<p>Are there any differences which make the organisations incompatible? What fits well?</p> <p>How effective are internal financial controls and do any areas need to be reviewed?</p>
Management letter from auditors	<p>Review auditor's copies of management letters from the last three years. These should include the charity's responses.</p>	<p>Is there anything of concern in the auditors or charities comments? Are there any possible defects in internal controls?</p>

Financial

b) Commitments and assets

Area to review	What to do	How to use this information/Questions to ask
Future funding	Review plans for funding in next 2/3 years.	Is it likely that future funding will be achieved?
Funding of projects	Check that the practice of full cost recovery is being followed and that budgets allow for a small surplus to be added to reserves.	What is the risk of undertaking projects where full cost recovery is not achievable and what will be the effect if those projects have to be subsidised from unrestricted funds?
Property and dilapidations	Obtain a list of properties. Perform a Land Registry search and obtain title deeds for freehold and leasehold properties. Check if cost exceeds market value in any cases. Review leases for dilapidation clauses.	Could losses arise if property has to be disposed of? Will the costs be very high if any leases are surrendered?
Fixtures and fittings	Get a register of fixed assets and reconcile the figures to the accounts. Check on sample basis fixtures and fittings.	Does the register represent the assets fairly? Are there assets which will be used in the merged organisation? Will some assets have to be disposed of at a loss?
Investments	Obtain a list of costs and value of investments.	Can you verify the legal title by checking certificates or other legal evidence?
Stocks	Obtain a list of stock and values. Attend a physical stock-take if the value of the stock is material.	Is there slow moving and obsolete stock that might lead to an overvaluation of stock?
Debtors	Obtain a list of debtors and amounts owed. Get direct third party verification on material amounts especially grant debtors.	Are adequate provisions in place for doubtful debts?
Prepayments	Obtain a list of prepayments. Verify a sample of prepayments.	Where prepayments relate to agreements that will be terminated does the value of the prepayment need to be reduced?
Bank	Obtain a list of bank balance(s) and check bank(s) reconciliations.	Are bank balances accurate? Are all bank accounts accounted for?
Creditors	Obtain a list of creditors and the amounts owing. Enquire into and consider getting direct third party verification on material and long standing amounts.	Are all creditors genuinely still owed or could there be problems with the records?
Debt and guarantees	Obtain details of terms for all debt, secured and unsecured and any guarantees. Review timing of debt repayments as part of cash flow analysis.	Can any terms, covenants and guarantees remain in place following merger?
Accruals	Obtain a list of accruals. Verify a sample.	Are potential liabilities being calculated on a reasonable basis and is the list complete?
Intangibles	Get details of patents, licences, brands and other intellectual property rights and goodwill together with copies of relevant agreements.	Is the valuation of intangibles reasonable?
Pension schemes	Specialist advice must be taken from the pension provider and other relevant professional advisors.	What sort of liabilities may arise if membership of the scheme is terminated either by staff leaving or transferring or by the merging organisation ceasing to exist?

Financial

c) Tax

Area to review	What to do	How to use this information/Questions to ask
Income tax and national insurance	Examine the payroll and find out the normal monthly liability for PAYE.	Is the amount owed for tax and National Insurance the payment for one month or for longer? Do there appear to be any overpayments and, if so, are they recoverable?
Corporate tax	Check that there is no liability to pay corporation tax on any form of trading or relating to non-charitable expenditure.	Discuss with tax advisors.
VAT	Check whether the organisation is VAT registered or should be. If so, check its procedures with regard to irrecoverable VAT.	Discuss with tax advisors.
Gift Aid	Obtain a list of donations on which gift aid is being recovered. Check on a sample basis whether the documentation is correct to enable recoveries be made.	Would an HMRC gift aid audit uncover liabilities for gift aid being reclaimed in error?

Legal

Area to review	What to do	How to use this information/Questions to ask
Power to merge	Get copies of current governing documents. Review the legal basis on which merger will proceed.	Is there power for the charities to merge in the governing documents?
Charity Commission involvement	Consider the need for Commission advice or authority.	Is there uncertainty about how to proceed? Would Charity Commission involvement assist?
TUPE and contracts of employment	Review contracts of employment and seek professional advice.	What are the implications for transferring staff including contracts of employment?
Property	Consider various clauses of leases such as dilapidation clauses and seek professional advice.	What are the implications of these? Act on professional advice.
Intellectual property	Obtain details of patents, trade marks and other intellectual property rights and seek professional advice.	What are the implications of these? Act on professional advice.
Other legal contracts	Review existing contracts.	Act on professional advice.
Public service delivery	Review existing contracts and contact awarding agency. Find out the views of the awarding agency to merger.	Act on professional advice.
Pensions	Review schemes and identify any issues. Determine if a deemed withdrawal or cessation event will be triggered and contact the Pensions Regulator.	Act on professional advice.
Insurance	Obtain details of all insurance policies and make contact with insurers.	What are the insurance requirements of the merged charity?
Permanent endowment	Obtain relevant trust deeds and other documentation.	Are the proposed arrangements for holding the permanent endowment legally sound? Act on professional advice.
Legacies	Consider reliance on future legacy income.	Is there a need to register the merger with the Commission?