Promoting Professionalism in Accountancy

INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS OF UGANDA

GUIDELINES FOR MERGER OF SMALL AND MEDIUM PRACTICES

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1.0 INTRODUCTION

The Institute of Certified Public Accountants of Uganda (ICPAU) was established in 1992 by The Accountants Act, Cap 266 as amended by The Accountants Act, 2013. The functions of the Institute, as prescribed by the Act, are to regulate and maintain the standard of accountancy in Uganda; and to prescribe and regulate the conduct of accountants in Uganda. Under its legal mandate, the Institute prescribes professional standards to be applied in the preparation and auditing of financial reports in Uganda.

1.1 Quality Assurance

In regard to the ICPAU's mandate of regulating and maintaining a vibrant accountancy profession in the country, the Institute has for long been subjecting all accountants in public practice to a periodical monitoring review as per the requirements of the International Federation of Accountants' 'Statement of Membership Obligation 1: Quality Assurance in order to ensure that accountants in public practice serve in public interest.

One of the functions of the Council of ICPAU, under the Accountants Act, 2013 Section 12(h), is to ensure the maintenance of professional standards by the members of the institute and to take steps to acquaint the members with methods and practices necessary to maintain those standards. It is on such a background that the Institute decided to develop these guidelines in pursuance of its desire to improve on the operations and quality of services members render to the public.

1.2 Objectives

The guidelines for merger of small- and medium-sized audit firms are aimed at encouraging sole practitioners to exploit the benefits of size in their operations. These guidelines are to be applied and adopted, as necessary, in the merging of audit firms and other business combination activities. The purpose is to have small firms exploit the avenues and synergies related to a bigger sizeable force in regard to securing work and ensuring quality services following complaints that some firms in Uganda cannot compete favorably for work in certain sectors most notably in the financial services sector with others because of their size.

It is to provide effective guidelines to be adopted by firms contemplating merger process. It is believed that the application of the guidelines would enhance fairness among stakeholders, resulting in:

- Effectiveness and efficiency of service delivery;
- Compliance with applicable laws and regulations
- Reliability of financial statements;
- Improvement on the networking of members;
- Promotion of the Standards of the Accountancy Profession; and
- Reduction of the audit expectation gap;

In order to understand and apply the basic principles of these guidelines, it is necessary to consider it in conjunction with ISQC 1. Again, firms wishing to merge should also comply with the requirements of the Institute's Audit Practice Guidelines.

2.0 DEMOGRAPHY OF AUDIT FIRMS IN UGANDA

The total number of Audit firms in Uganda as at 31 May 2013 is approximately 192 (One hundred and ninety two). This number is made up of the following categories of firms:

Number of Partner (s)	Number of Firms	%
ONE	105	54.7
TWO	67	34.9
THREE	16	8.3
FOUR	3	1.6
FIVE	1	0.5
TOTAL	**192**	**100**

From the table above it is evident that sole proprietorship comprises the highest number of practising firms in Uganda. The table shows that out of 192 practising firms, one partner firms are 105 (One hundred five) which is 54.7% of all the practising firms.
The reasons for the dominance of this type of business association include:

- The ease and less cost associated with the formation of this business mode
- Unwillingness of the sole practitioner to lose control.
- Inability to look beyond the environment.
- Lack of collaboration among Certified Public Accountants.
- The desire for a modest work-life balance.
- Lack of specialization
- Lack of consideration for the business-formation decision
- The desire to work independently and take all the profit.

From the audit monitoring exercise carried out so far by the Institute, it is evident that most sole practitioners and other small audit firms are faced with operational challenges in practice and as a result adopt different survival tactics which impact negatively on the quality of services rendered to their clients. This is also connected to the likely risk that may befall these firms in the case of a worst case scenario in regard to a law suit against the firms. The continued challenges of sole practitioners especially; sole financial responsibility, sole legal liability, tax liability, discrimination in the market among others has seen such firms stagnate for quite a remarkable period.

3.0 CHARACTERISTICS OF BUSINESS MODELS

3.1 Sole practitioner

This is a model in which the firm is owned by one person, usually the individual who has day-to-day responsibilities for running the firm. He takes all the initiatives and runs the firm relying on his knowledge and skill. The vast majority of small firms start out as sole practitioners. These individuals own the assets of the firm and the profits generated by it.
They also assume complete responsibility for any of its liabilities or debts. In the eyes of the law and the public, the individual and the firm are one. This model is prevalent in accounting profession and should be discouraged due to various challenges confronting it.

Notwithstanding, Sole proprietorship has the following advantages:

- Profit is entirely for the owner;
- Decisions are often taken quickly;
- There is privacy;
- Limited capital required to start the firm.

However, it has the following disadvantages:

- Lack of continuity after the death of the owner;
- Lack of adequate finance for expansion;
- Poor quality of work;
- Lack of specialization;
- Inability to obtain big engagements;
- Inability to train and retain qualified staff;
- Inadequate documentation of records;
- Lack of collaboration with other firms to improve quality of service;
- Inability to attend various training programmes for lack of time;
- Makes acquisition of expertise difficult; and
- Lack of a viable succession plan.

With an emerging oil and gas sector, the telecommunication sector, financial services sector and the increasing legislation followed by the need for prudent financial statement reporting, firms need to come together to harness the new developments. Continued sole stratification/segmentation is likely to hamper growth of the firms the more and hence providing a very fertile platform for other well established operatives within the East African Community and beyond.

It is against this background that the Institute is encouraging practising firms, especially like-minded sole practitioners, to merge their practices so that they can reap the benefits of size. It will also enhance the quality and quantity of service delivery to clients and ensure a sustainable growth.

3.2 Partnership

Partnership is the relation which subsists between persons carrying on a business in common, with a view of profit. It has also been defined as two or more independent bodies working collectively to achieve more effective outcomes than they could by working separately. The partners should have a legal agreement that sets forth how decisions will be made, profits will be shared, disputes will be resolved, how future partners will be admitted to the partnership, how partners can be bought out, succession planning and what steps will be taken to dissolve the partnership when needed. Partnerships must also decide upfront how much time and capital each will contribute to the partnership. It is in line with these benefits that partnership through merger is being encouraged among audit firms.

3.2.1 Rules for determining existence of Partnership

In determining whether a partnership does or does not exist, regard shall be given to the following rules:

- Joint tenancy, tenancy in common, joint property, common property, or part ownership does not of itself create a partnership as to anything so held or owned, whether the tenants or owners do or do not share any profits made by the use thereof.

- The sharing of gross returns does not of itself create a partnership, whether the persons sharing those returns have or have not a joint or common right or interest in any property from which, or from the use of which, the returns are derived.

- The receipt by a person of a share of the profits of a business is prima facie evidence that he or she is a partner in the business, but the receipt of such a share, or of a payment contingent on or varying with the profits of a business, does not of itself make him a partner in the business; and in particular-

- The receipt by a person of a debt or other liquidated amount by installments or otherwise out of the accruing profits of a business does not of itself make him a partner in the business or liable as such;

- A contract for the remuneration of a servant or agent of a person engaged in a business by a share of the profits of the business does not of itself make the servant or agent a partner in the business or liable as such;

- A person being the widow or child of a deceased partner, and receiving by way of annuity a portion of the profits made in the business in which the deceased person was a partner, is not by reason only of such receipt a partner in the business or liable as such;

- The advance of money by way of loan to a person engaged or about to engage in any business on a contract with that person that the lender shall receive a rate of interest varying with the profits, or shall receive a share of the profits arising from carrying on the business, does not of itself make the lender a partner with the person or persons carrying on the business or liable as such provided that the contract is in writing and signed by or on behalf of all the parties thereto; and

- A person receiving by way of annuity or otherwise a portion of the profits of a business in consideration of the sale by him of the goodwill of the business is not by reason only of such receipt a partner in the business or liable as such.

4.0 BUSINESS INTEGRATION

There are various types of business integration to which a Partnership model could be involved.

4.1 Complete integration/partnership

This is a partnership in which the individual firms lose their identity to form a new organization. This is also known as realigning organizational boundaries that entail bringing together the whole or parts of two or more organizations to create a new organization.

4.2 Strategic alliances

This is an integration model in which organizations identify their areas of strengths and weaknesses so as to determine the basis of working together. This entails alliance by liaison, consultations and through mutual agreement. A typical strategic alliance formation process involves; strategy development, partner assessment, contract negotiation, alliance operation and alliance termination. This form of cooperation lies between mergers and acquisitions and organic growth. However, those who wish to adopt this model are strongly advised to have a written agreement for the integration.

Examples of Strategic Alliance are:

- *Alliance through areas of specialization*: Such as Taxation, Receivership, Liquidation etc.
- *Alliance through sharing of resources*: Such as Technical, Financial, and Human Resources etc
- *Big firms co-opting small firms through the following*:
  - Information sharing
  - Coordinating and consulting
  - Joint management

4.3 Merger/Acquisition

Merger: A merger is viewed as the situation where two or more firms combine together to form a larger business entity.
Acquisition: This involves outright purchase of another firm or purchase of controlling shares in another firm

5.0 FIRM MERGER

5.1 General Principles

One plus one makes three: this equation is the special alchemy of a merger or an acquisition. The key principle behind buying a firm is to create shareholder value over and above that of the sum of the two firms. Two firms together are more valuable than two separate firms - at least, that's the reasoning behind Mergers & Acquisitions

A merger occurs when two or more firms agree to form a single new firm rather than remain separately owned and operated. This kind of action is more precisely referred to as “merger of equals”. The firms are often about the same size. In practice however, actual mergers of equals rarely happen. What usually happens is that one firm will buy another and as part of the terms of the deal simply allows the acquired firm to proclaim that the action is a merger of equals, even if it is technically an acquisition. A merger in the official sense is said to be worth when both businesses dissolve and double their assets and convert into a newly created third unit. Most of the mergers are friendly rather being a forced affair.

On the other hand, acquisition occurs when one firm takes over another and clearly establishes itself as the new owner. From a legal point of view, the target firm ceases to exist. In this case one firm actually buys another firm. In take-over or acquisition, generally, a larger firm buys a smaller one. There are two types of acquisitions. One form of acquisition is when the firm purchases the shares from the share owners of the firm which is undergoing the takeover. Another form is when the firm buys only selected assets of a firm.

5.2 Advantages of Merger

- It increases efficiency;
- Prevents duplication of facilities;
- Diversification to reduce risk;
- Synergistic effect;
- Reduces or prevents escalation of administrative costs/overheads;
- Broadening of knowledge pool, experience and skill from which the firm can draw internally;

- Increases fundraising ability thus ensuring larger pool of resources for optimal performance of the firm;
- It encourages geographical spread.

5.3 Disadvantages of Merger

Though merger is being encouraged among practising firms, it has the following shortcomings which however should not prevent firms from merging:

- Friction may arise between the management of the firms;
- Dissenting staff of the big firms may kick against the merger to protect their job.;
- Challenges of aligning firm's culture;
- Practitioners' sense of loss of control;
- Discomfort with share allocation, decision-making and profit sharing.

5.4 Why external growth through merger is preferable to internal growth

- Firms want diversification to reduce the risks involved with a seasonal business.
- A firm expects a synergistic effect by merging with another.
- A merger permits small firms to obtain something it lacks, such as superior management talent and or a research capability and other economies of scale.
- A firm improves its ability to raise funds when it combines with another having highly liquid assets and low debt.
- The goodwill of a large firm is usually more acceptable than that of a small one. This attribute results in marketing the firm to clientele.
- In some cases, it is easier to finance a merger than to finance internal expansion.

6.0 PRE-MERGER DUE DILIGENCE

Due diligence is a process of thorough and objective examination that is undertaken before corporate entities enter into major transactions such as mergers and acquisitions, etc. One of the key objectives of due diligence is to minimize, to the maximum extent practicable, the possibility of there being unknown liabilities or risks. The exercise is multi-dimensional and involves investigation into the business, tax, financial, accounting and legal aspects of an issuer. Due diligence on all the firms wishing to merge is an imperative exercise.

It covers the following areas:

(a) Operational due diligence – This looks at the main operations of the target firm and attempts to confirm (or not) that the business plan that has been provided is achievable with the existing operational facilities plus the capital expenditure that is outlined in the business plan.

(b) Human Resource due diligence - Identification of material human resource risks early in the due diligence process is key to any merger. The financial risks associated with human resources may have a significant impact on the valuation and ultimate considerations one firm would have over the other.

(c) Legal due diligence - this involves review of documentation to identify potential legal issues that may be risks/impediments to the transaction or in the general operations of the issuer, that may affect the value or consideration in connection with the transaction.

(d) Financial due diligence - involves review of tax, financial position, policies and internal controls among others.

7.0 CONCLUSION

In a wake of a growing economy with an increasing demand for professional services, existing practising firms shall benefit from this growth by ensuring that they endeavor to appear capable of performing any engagements assigned to them. As a basic assurance, firms should in the public's perception be seen to have a fully committed basket of resources, (financial, human and technical abilities) that can enable them perform outstanding services to their clients. With the guidance above, we wish to challenge any like-minded sole practitioners; to merge their practices so that they can reap the economies of size; like enhanced the quality and quantity of service delivery to clients for a sustainable growth. For those who intend to do so, please refer to **Appendix I** for a step by step guidance.

APPENDIX I: PARTNERSHIP/MERGER CHECKLIST

S/N	ISSUE	RESPONSE DATE	PERSON RESPONSIBLE
1.	All parties to sign confidentiality agreement		
2.	List terms and conditions required to the merger		
3.	Agree on new entity structure		
4.	Agree on management, dispute resolution, exit provisions, succession planning, valuation formula and capital investment.		
5.	Agree on services to be provided		
6.	Agree on decision-making process		
7.	Determine process for deciding on managing partner		
8.	Develop partnership/shareholders agreement		
9.	Determine partners' specialties for the services offered by the firm		
10.	Determine partners' remuneration		
11.	Determine partners' access to profits		
12.	Agree on charge-out rates		
13.	Agree on target client profile		
14.	Agree on the guidance for any existing client outside of new client profile.		
15.	Determine time period allowed and scope of due diligence on each other's firm.		
16.	Agree on valuation of each firm's interest at time of initial merger		
17.	Determine valuation formula and process on partner exit		
18.	Agree on location and number of offices to be maintained		
19.	Assess office and storage requirements		
20.	Agree on organization chart, partner responsibilities and staff structure		
21.	Agree on quality control, systems and procedures to be used		
22.	Determine computer hardware and software platforms to be used, including accounting, tax and firm management database		
23.	Agree the responsible party for all law and regulatory requirements for the firm		
24.	Determine employment terms for all staff and review salary levels for equitability		
25.	Consider any staff redundancies		
26.	Determine working capital requirements and funding for the firm		
27.	Agree on firm's bankers		
28.	Agree on firm's lawyers		
29.	Agree on professional indemnity insurer and any other form of insurance cover		
30.	Agree on firm's name/logo		
31.	Provide access to historic information on client base, fees by client and fees by service range for due diligence purposes		
32.	Agree as to whether pre-merger debtors and creditors are to be combined in the new firm or collected separately post-merger		